CONSUMER CREDIT IN THE UNITED STATES

REPORT OF
THE NATIONAL COMMISSION
ON CONSUMER FINANCE

DECEMBER 1972

LIBRARY OF CONGRESS CARD NUMBER 72 – 600335

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, D.C. 20402 - Price $3.20 domestic postpaid or $2.75 GPO Bookstore
Stock Number 5200-00005

NATIONAL COMMISSION ON CONSUMER FINANCE
1016 – 16TH STREET, N.W.
WASHINGTON, D.C. 20036

December 31, 1972

To the President and Congress of the United States:

The National Commission on Consumer Finance, established by Public Law 90-321, submits herewith its Report which includes the Commission's findings and recommendations in the field of consumer credit. The Commission's studies, enumerated in the Report, contain the empirical data, information and analyses relied upon by the Commission. It is our belief that such data and extensive studies, which we are making available to the public, are as important as the Report itself. They will provide a fresh basis for all concerned with this significant industry to consider its future in an era of increasing public awareness.

As to the Report itself, I believe the Commission was unanimous in concluding that a truly competitive consumer credit market, with adequate disclosure of relevant facts to an informed consuming public, together with legislation and regulation to eliminate excesses, will foster economic growth and serve to optimize benefits to the consumer.

As to excesses in the marketplace, our Report recommends significant additions to the protection of consumers in the fields of creditors' remedies and collection practices. We have urged restrictions on remedies such as garnishment, repossession, and wage assignment. We have recommended abolition of the holder in due course doctrine, confessions of judgment, and harassing tactics in debt collections.

As to adequate disclosure of relevant facts, our Report urges enhanced supervision and enforcement of the Federal Truth in Lending Act. We have also specified actions to make the disclosure features of Truth in Lending more effective and have suggested expanding the coverage of that Act to include disclosure of charges for credit life and accident and health insurance as an annual percentage rate.

We also favored making federally chartered financial institutions subject to state as well as Federal examination for compliance with state laws governing the terms and conditions of consumer credit extensions. In addition, we recommended expanded administrative authority over all classes of creditors.

As to our conclusion that free and fair competition is the ultimate and most effective protector of consumers, we have recommended the elimination of restrictive barriers to entry in consumer credit markets by permitting all creditors open access to all areas of consumer credit. We have urged the entry of savings and loan associations and mutual savings banks into the consumer credit market. We have recommended prohibitions on acquisitions that would eliminate potential competition or that would substantially increase concentration in state or local credit markets. We have also urged that rate ceilings which constrain the development of workably competitive markets be reviewed by those states seeking to increase credit availability at reasonable rates. Some controversy has developed as to whether the Commission approved a specific rate structure including 42 percent on smaller loans. The Commission has never voted for such a rate structure and does not endorse it.

Finally, I would note that the gathering and analyzing of original data, and preparing the Commission's Report have been an arduous task for which I extend special thanks to a devoted and hard-working Commission staff under the leadership of its Director, Robert L. Meade. Among the many experts who assisted our work, special recognition must be given to Professor Robert P. Shay, of Columbia's Graduate School of Business, who contributed significantly to the design of studies. I also, of course, thank the members of the Commission who have given their time and effort, as well as their knowledge and expertise, to the difficult task with which the Commission was faced.

We hope that our Report and the accompanying data and studies will provide a healthy climate for informed and intelligent discussion and continuing research in this vital area.

Ira M. Millstein

Ira. M. Millstein
Chairman

The President
The President of the Senate
The Speaker of the House of Representatives

MEMBERS OF THE COMMISSION

Appointed by the President

Ira M. Millstein, *Chairman*
Attorney
New York, New York

Appointed Chairman January 20, 1971
to succeed Robert Braucher

Dr. Robert W. Johnson
Professor, Purdue University
Lafayette, Indiana

Hon. Douglas M. Head
Attorney
Minneapolis, Minnesota

Appointed February 16, 1971

Appointed by the President of the Senate

Hon. John Sparkman
Senator from Alabama

Hon. William Proxmire
Senator from Wisconsin

Hon. William E. Brock
Senator from Tennessee

Appointed April 5, 1971 to succeed
Hon. John G. Tower
Senator from Texas

Appointed by the Speaker of the House of Representatives

Hon. Leonor K. Sullivan
Representative from Missouri

Hon. Henry B. Gonzalez
Representative from Texas

Appointed March 10, 1971 to succeed
Hon. Wright Patman
Representative from Texas

Hon. Lawrence G. Williams
Representative from Pennsylvania

Appointed March 10, 1971 to succeed
Hon. Seymour Halpern
Representative from New York

STAFF OF THE COMMISSION

Robert L. Meade
Executive Director

Ruth K. Holstein
Public Information Officer

Donald B. Harper
Administrative Officer

Legal

Milton W. Schober
General Counsel

Stephen M. Crane[1]

Alan R. Feldman
Counsel

Economics

Douglas F. Greer
Consultant
Ernest A. Nagata
Harrison F. Houghton[2]

Robert P. Shay
Consultant
Richard K. Slater
George M. Lumbard

Research Assistant

Patricia A. Massey[3]

Data Processing

William C. Paris

Fred E. Marmarosh

Fern B. Horwitz

Administrative and Clerical

Mildred F. Dolan
Administrative Assistant

Doris Baenziger
Dimitrios D. Drivas
Rebecca S. Klein
Victoria A. Sackett

Cheryl Bleiberg
Donald J. Hardesty
Louise R. Neely
Gwendolyn D. Smith

Charles A. Banister, III
Helen I. Jackson
Karen L. Ryscavage
Patricia D. Smith

Other Consultants

Wilbur H. Baldinger
Corwin D. Edwards

James A. Bayton
Paul F. Smith

John W. Boyer
William D. Warren

Part-time Student Assistants

John A. Bryson; Claudia C. Dawson; Beverly A. Eiserer; John C. Firman; Deborah Flint; Stephen A. Flynn; George F. Foote; David E. Fox; Thomas L. Gough; Eftekhar Hadjimirvahabi; William M. Hannay; Larry Harbin; Jane A. Harding; Richard D. Hardesty; Pamela R. Hevey; Cain J. Kennedy; Lowell S. Lease; Jessica A. Licker; William F. Livingston; James F. Lonergan; Arthur M. Mason; Michael J. McElligott; Terence P. McLarney; Mark R. Mendenhall; Michael J. Merenda; Nonnie F. Midgette; Rosemary A. Mitchell; Michael B. Moore; Philip B. Nelson; Stephen R. Pittman; Arthur F. Richardson; Eric D. Roiter; Marvin L. Schwartz; Terry G. Seaks; Robert A. Simpson; Patricia Spillenkothen; Penelope Williams; and David R. Yost.

[1] Until February 5, 1972   [2] Until September 4, 1971   [3] Until November 3, 1971

FOREWORD

The National Commission on Consumer Finance, established by Title IV of the Consumer Credit Protection Act of 1968 (Public Law 90-321), attained its full membership on November 7, 1969 when the President named three public members and designated one of them Chairman.

As originally constituted, Commission members included Robert Braucher, professor of law at Harvard University, who was named Chairman; Robert W. Johnson, professor of finance at Purdue University; and Ira M. Millstein, member of the New York Bar, Presidential appointees; Senator John J. Sparkman, Senator William Proxmire, and Senator John G. Tower, Senate appointees; and Representative Wright Patman, Representative Leonor K. Sullivan, and Representative Seymour Halpern, House of Representatives appointees.

When Chairman Braucher subsequently became an Associate Justice of the Supreme Judicial Court of Massachusetts, the President designated Mr. Millstein as Commission Chairman and named Douglas M. Head, former Attorney General for the State of Minnesota, to fill the vacancy. Later, when Senator Tower found it necessary to resign, he was replaced by Senator William E. Brock, and when Representatives Patman and Halpern also found it necessary to relinquish membership, they were replaced by Representative Henry B. Gonzalez and Representative Lawrence G. Williams. Despite these membership changes, however, a majority of the members and the Commission's executive director, Robert L. Meade, have served during the Commission's entire existence. Continuity was further achieved through monthly meetings and frequent written communications.

In a consumer message to Congress on October 30, 1969 President Nixon noted that total consumer credit outstanding had grown during the last 25 years from \$5.7 billion to \$100 billion and that Government supervision and regulation of consumer credit had become increasingly complex and difficult. The Commission, he said, "should begin its important work immediately."

Because of the wide area such a comprehensive subject could encompass, the Commission had to narrow the scope of its work to fit its funding and time limitations. Even so, the Commission twice had to ask Congress for additional time and once for additional funds. Certainly due in no small part to the interest, understanding, and generosity of the Congress, the Commission now offers this final Report to fulfill its Congressional mandate.

The Commission is confident that it has pioneered in collecting and presenting heretofore unobtainable data and ground-breaking studies and analyses. In and of themselves, the collection and dissemination of these data, the studies, and the analyses will provide a fresh and empirical basis for legislators, the industry, and scholars to consider.

Many of the supporting studies are being published as supplements to the final report for the use of legislators, the industry, scholars, and others interested in the basic data. Unpublished data and studies as well as computer tapes can be read at the records center of the National Archives and Records Service, Washington, D.C.

As to the findings, conclusions, and recommendations contained in the report, these were prepared by the Commission staff based upon the data, studies, and analyses collected by the Commission and, more importantly, based upon the numerous meetings of the Commission throughout its life at which all the Commissioners had the opportunity to present their respective views as the work progressed. As in any report of this nature, not all of the Commissioners agreed with all of the findings, conclusions, and recommendations, as evidenced by the separate views expressed by the individual members, which separate views follow the body of the report.

During the course of its study, the Commission held three public hearings in Washington, D.C. to obtain facts and views from individuals, consumer organizations, industry, and Government on the subjects of debt collection practices, responsibility for enforcement of consumer credit protection laws, and the availability of consumer credit to women. The Commission publicly acknowledges its gratitude to witnesses who appeared at the hearings to provide invaluable information related to ever increasing complexities in

the consumer credit field. The Commission also notes its gratitude to thousands of credit industry officials who spent hours of time and effort in completing Commission questionnaires which provided priceless data. Obviously, their assistance in providing data does not necessarily indicate their concurrence with the report and its recommendations.

Although this report is directed to the President and to the Congress, the Commission hopes that consumers, the consumer credit industry, state legislative bodies, and professional and academic communities will also find that it adds substantially to their understanding of a growing industry and a complex subject.

Contents

SUMMARY OF RECOMMENDATIONS

Contract Provisions and Creditors' Remedies (Chapter 3)

Contract Provisions

Acceleration Clauses - Default - Cure of Default

Acceleration of the maturity of all or any part of the amount owing in a consumer credit transaction should not be permitted unless a default as specified in the contract or agreement has occurred.

A creditor should not be able to accelerate the maturity of a consumer credit obligation, commence any action, or demand or take possession of any collateral, unless the debtor is in default, and then only after he has given 14 day's prior written notice to the debtor of the alleged default of the amount of the delinquency (including late charges), of any performance in addition to payment required to cure the default and of the debtor's right to cure the default.

Under such circumstances, for 14 days after notice has been mailed, a debtor should have the right to cure a default arising under a consumer credit obligation by:

1. tendering the amount of all unpaid instalments due at the time of tender, without acceleration, plus any unpaid delinquency charges; and by
2. tendering any performance necessary to cure a default other than nonpayment of accounts due.

However, a debtor should be able to cure no more than three defaults during the term of the contract. After curing default, the debtor should be restored to all his rights under the consumer credit obligation as though no default had occurred.

Attorney's Fees

Consumer credit contracts or agreements should be able to provide for payment of reasonable attorney's fees by the debtor in the event of default if such fees result from referral to an attorney who is not a salaried employee of the creditor; in no event should such fees exceed 15 percent of the outstanding balance. However, the agreement should further stipulate that in the event suit is initiated by the creditor and the court finds in favor of the consumer, the creditor should be liable for the payment of the debtor's attorney's fees as determined by the court, measured by the amount of time reasonably expended by the consumer's attorney and not by the amount of the recovery.

Confessions of Judgment - Cognovit Notes

No consumer credit transaction contract should be permitted to contain a provision whereby the debtor authorizes any person, by warrant of attorney or otherwise, to confess judgment on a claim arising out of the consumer credit transaction without adequate prior notice to the debtor and without an opportunity for the debtor to enter a defense.

Cross-Collateral

In a consumer credit sale, the creditor should not be allowed to take a security interest in goods or property of the debtor other than the goods or property which are the subject of the sale. In the case of "add-on" sales, where the agreement provides for the amount financed and finance charges resulting from additional sales to be added to an existing outstanding balance, the creditor should be able to retain his security interest in goods previously sold to the debtor until he has received payments equal to the sales price of the goods (including finance charges). For items purchased on different dates, the first purchased should be deemed the first paid for; and for items purchased on the same date, the lowest priced items should be deemed the first paid for.

Household Goods

A creditor should not be allowed to take other than a purchase money security interest in household goods.

Security Interest - Repossession - Deficiency Judgments

A seller-creditor should have the right to repossess goods in which a security interest exists upon default of contract obligations by the purchaser-debtor. At the time the creditor sends notice of the cure period (14 days), and prior to actual repossession (whether by replevin with the aid of state officers or by self-help), the creditor may simultaneously send notice of the underlying claim against the debtor and the debtor should be afforded an opportunity to be heard in court on the merits of such claim. The time period for an opportunity to be heard may run concurrently with the cure period.

Where default occurs on a secured credit sale in which the original sales price was $1,765 or less, or on a loan in which the original amount financed was $1,765 or less and the creditor took a security interest in goods purchased with the proceeds of such loan or in other collateral to secure the loan, the creditor should be required to elect remedies: either to repossess collateral in full satisfaction of the debt without the right to seek a deficiency judgment, or to sue for a personal judgment on the obligation without recourse to the collateral, but not both.

Wage Assignments

In consumer credit transactions involving an amount financed exceeding $300, a creditor should not be permitted to take from the debtor any assignment, order for payment, or deduction of any salary, wages, commissions, or other compensation for services or any part thereof earned or to be earned. In consumer credit transactions involving an amount financed of $300 or less, where the creditor does not take a security interest in any property of the debtor, the creditor should be permitted to take a wage assignment but in an amount not to exceed the lesser of 25 percent of the debtor's disposable earnings for any workweek or the amount by which his disposable earnings for the workweek exceeds 40 times the Federal minimum hourly wage prescribed by section 6(a) (1) of the Fair Labor Standards Act of 1938 in effect at the time.

Creditors' Remedies

Body Attachment

No creditor should be permitted to cause or permit a warrant to issue against the person of the debtor with respect to a claim arising from a consumer credit transaction. In addition, no court should be able to hold a debtor in contempt for failure to pay a debt arising from a consumer credit transaction until the debtor has had an actual hearing to determine his ability to pay the debt.

Garnishment

Prejudgment garnishment, even of nonresident debtors, should be abolished. After entry of judgment against the debtor on a claim arising out of a consumer credit transaction, the maximum disposable earnings of a debtor subject to garnishment should not exceed the lesser of:

1. 25 percent of his disposable earnings for the workweek, or
2. The amount by which his disposable earnings for the workweek exceeds 40 times the Federal minimum hourly wage prescribed by section 6(a) (1) of the Fair Labor Standards Act of 1938, in effect at the time the earnings are payable. (In the event of earnings payable for a period greater than a week, an appropriate multiple of the Federal minimum hourly wage would be applicable.)

A debtor should be afforded an opportunity to be heard and to introduce evidence that the amount of salary authorized to be garnished would cause undue hardship to him and/or his family. In the event undue hardship is proved to the satisfaction of the court, the amount of the garnishment should be reduced or the garnishment removed.

No employer should be permitted to discharge or suspend an employee solely because of any number of garnishments or attempted garnishments by the employee's creditors.

Holder in Due Course Doctrine-Waiver of Defense Clauses-Connected Loans

Notes executed in connection with consumer credit transactions should not be "negotiable instruments;" that is, any holder of such a note should be subject to all the claims and defenses of the maker (the consumer-debtor). However, the holder's liability should not exceed the original amount financed. Each such note should be required to have the legend "Consumer Note - Not Negotiable" clearly and conspicuously printed on its face.

Holders of contracts and other evidences of debts which are executed in connection with consumer credit transactions other than notes should similarly be subject to all claims and defenses of the consumer-debtor arising out of the transaction, notwithstanding any agreement to the contrary. However, the holder's liability should not exceed the original amount financed.

A creditor in a consumer loan transaction should be subject to all of the claims and defenses of the borrower arising from the purchase of goods or services purchased with the proceeds of the loan, if the borrower was referred or otherwise directed to the lender by the vendor of those goods or services and the lender extended the credit pursuant to a continuing business relationship with the vendor. In such cases, the lender's liability should not exceed the lesser of the amount financed or the sales price of the goods or services purchased with the proceeds of the loan.

Levy on Personal Property

Prior to entry of judgment against a debtor arising out of a consumer credit transaction, while a court may create a lien on the personal property of the debtor, that lien should not operate to take or divest the debtor of possession of the property until final judgment is entered. However, if the court should find that the creditor will probably recover in the action, and that the debtor is acting or is about to act in a manner which will impair the creditor's right to satisfy the judgment out of goods upon which a lien has been established, the court should have authority to issue an order restraining the debtor from so acting. The following property of a consumer debtor should be exempt from levy, execution, sale, and other similar process to satisfy judgment arising from a

496-072 O - 73 - 2

consumer credit transaction (except to satisfy a purchase money security interest created in connection with the acquisition of such property).

1. A homestead to the fair market value of $5,000 including a house, mobile home, or like dwelling, and the land it occupies if regularly occupied by the debtor and/or his family as a dwelling place or residence and intended as such.

2. Clothing and other wearing apparel of the debtor, spouse, and dependents to the extent of $350 each.

3. Furniture, furnishings, and fixtures ordinarily and generally used for family purposes in the residence of the debtor to the extent of the fair market value of $2,500.

4. Books, pictures, toys for children and other such kinds of personal property to the extent of $500.

5. All medical health equipment being used for health purposes by the debtor, spouse, and dependents.

6. Tools of trade, including any income-producing property used in the principal occupation of the debtor, not to exceed the fair market value of $1,000.

7. Any policy of life or endowment insurance which is payable to the spouse or children of the insured, or to a trustee for the benefit of the spouse or children of the insured, except the cash value or any accrued dividends thereof.

8. Burial plots belonging to the debtor and/or spouse or purchased for the benefit of minor children to the total value of $1,000.

9. Other property which the court may deem necessary for the maintenance of a moderate standard of living for the debtor, spouse, and dependents.

Contacting Third Parties

No creditor or agent or attorney of a creditor before judgment should be permitted to communicate the existence of an alleged debt to a person other than the alleged debtor, the attorney of the debtor, or the spouse of the debtor without the debtor's written consent.

Miscellaneous Recommendations

Balloon Payment

With respect to a consumer credit transaction, other than one primarily for an agricultural purpose or one pursuant to open end credit, if any scheduled payment is more than twice as large as the average of earlier scheduled payments, the consumer should have the right to refinance the amount of that payment at the time it is due without penalty. The terms of the refinancing should be no less favorable to the consumer than the terms of the original transaction. These provisions do not apply to a payment schedule which, by agreement, is adjusted to the seasonal or irregular income of the consumer.

Cosigner Agreements

No person other than the spouse of the principal obligor on a consumer credit obligation should be liable as surety, cosigner, comaker, endorser, guarantor, or otherwise assume personal liability for its payment unless that person, in addition to signing the note, contract, or other evidence of debt also signs and receives a copy of a separate cosigner agreement which explains the obligations of a cosigner.

Rebates for Prepayment

A consumer should always be allowed to prepay in full the unpaid balance of any consumer credit obligation at any time without penalty. In such instances, the consumer should receive a rebate of the unearned portion of the finance charge computed in

accordance with the "balance of the digits" (otherwise known as "sum of the digits" or "rule of 78's" method) or the actuarial method. For purpose of determining the instalment date nearest the date of prepayment, any prepayment of an obligation payable in monthly instalments made on or before the 15th day following an instalment due date should be deemed to have been made as of the instalment due date, and if prepayment occurs on or after the 16th it should be deemed to have been made on the succeeding instalment due date. If the total of all rebates due to the consumer is less than $1 no rebate should be required.

In the event of prepayment, the creditor should not be precluded from collecting or retaining delinquency charges on payments due prior to prepayment.

In the case of credit for defective goods, the consumer should be entitled to the same rebate as if payment in full had been made on the date the defect was reported to the creditor or merchant.

If the maturity of a consumer credit obligation is accelerated as a result of default, and judgment is obtained or a sale of secured property occurs, the consumer should be entitled to the same rebate that would have been payable if payment in full had been made on the date judgment was entered or the sale occurred.

Upon prepayment in full of a consumer credit obligation by the proceeds of credit insurance, the consumer or his estate should be entitled to receive the same rebate that would have been payable if the consumer had prepaid the obligation computed as of the date satisfactory proof of loss is furnished to the company.

Unfair Collection Practices

Harassment

No creditor, agent or attorney of the creditor, or independent collector should be permitted to harass any person in connection with the collection or attempted collection of any debt alleged to be owing by that person or any other person.

Sewer Service

If a debtor has not received proper notice of the claim against him and does not appear to defend against the claim, any judgment entered shall be voided and the claim reopened upon the debtor's motion.

Inconvenient Venue

No creditor or holder of a consumer credit note or other evidence of debt should be permitted to commence any legal action in a location other than (1) where the contract or note was signed, (2) where the debtor resides at the commencement of the action, (3) where the debtor resided at the time the note or contract was made, or (4) if there are fixtures, where the goods are affixed to real property.

Debtors in Distress

Consumer Credit and Consumer Insolvency

Chapter XIII of the Bankruptcy Act should be expanded as endorsed by the House of Delegates of the American Bar Association in July 1971 to permit Chapter XIII courts, under certain circumstances, to alter or modify the rights of secured creditors when they find that the plan adequately protects the value of the collateral of the secured creditor.

In petitions for relief in bankruptcy, the bankruptcy court should disallow claims of creditors stemming from "unconscionable" transactions.

Bankruptcy courts should provide additional staff to serve as counselors to debtors regarding their relations with creditors, and their personal, credit, and domestic problems.

Door-to-Door Sales

In any contract for the sale of goods entered into outside the creditor's place of business and payable in more than four instalments, the debtor should be able to cancel the transaction at any time prior to midnight of the third business day following the sale.

Assessment of Damages

If a creditor in a consumer credit transaction obtains a judgment by default, before a specific sum is assessed the court should hold a hearing to establish the amount of the debt the creditor-plaintiff is lawfully entitled to recover.

Supervisory Mechanisms (Chapter 4)

The Commission recommends that:

Legislatures and administrators in states with less than 2-1/2 man-days available per year per small loan office reassess their staffing capabilities with the goal of improving their ability to fulfill the examination responsibility prescribed by law.

All Federal regulatory agencies adopt and enforce uniform standards of Truth in Lending examination.

Congress create within the proposed Consumer Protection Agency a unit to be known as the Bureau of Consumer Credit (BCC) with full statutory authority to issue rules and regulations and supervise all examination and enforcement functions under the Consumer Credit Protection Act, including Truth in Lending; an independent Consumer Credit Agency be created in the event that the proposed Consumer Protection Agency is not established by Congress; the independent agency would have the same functions and authorities recommended for the Bureau of Consumer Credit.

Agencies supervising federally chartered institutions undertake systematic enforcement of Federal credit protection laws like Truth in Lending.

Federal law be expressly changed to authorize state officials to examine federally chartered institutions for the limited purpose of enforcing state consumer laws, but such authorization should in no way empower state officials to examine federally chartered institutions for soundness, fraudulent practices, or the like; the limited state examinations should be required by law to be performed in a manner that would not disrupt or harass the federally chartered institutions.

State consumer credit laws be amended to bring second mortgage lenders and any other consumer lenders under the same degree of administrative control imposed on licensed lenders.

Congress consider whether to empower state officials to enforce Truth in Lending and garnishment restrictions of the Consumer Credit Protection Act and any similar laws that may be enacted.

State laws covering retailers and their assignees be amended, where necessary, to give authority to a state administrative agency to enforce consumer credit laws against all sellers who extend consumer credit; but administrative regulation need not and should not entail either licensing or limitations on market access.

States which do not subject sales finance companies to enforcement of consumer credit laws amend their laws to bring such companies under enforcement; such authority need not and should not entail licensing or limitations on market access.

State laws be amended to give a state administrative agency authority to enforce consumer credit laws against all credit grantors—deposit holding institutions, nondeposit

holding lenders, and retailers and their assignees. This authority should include the right to enter places of business, to examine books and records, to subpoena witnesses and records, to issue cease and desist orders to halt violations, and to enjoin unconscionable conduct in making or enforcing unconscionable contracts. The agency should be able to enforce the right of consumers, as individuals or groups, to refunds or credits owing to them under appropriate statutes.

Legal services programs—legal aid, neighborhood legal services, rural legal assistance, public defender—continue to receive Federal, state, and local government support.

Consumer protection laws be amended, where necessary, to assure payment of legal fees incurred by aggrieved private consumers and provide them with remedies they can enforce against creditors who violate these laws.

The proposed BCC be authorized to establish a National Institute of Consumer Credit to function as the BCC's research arm.

The BCC, acting through the National Institute of Consumer Credit, be empowered to cooperate with and offer technical assistance to states in matters relating to consumer credit protection—examinations, enforcement, and supervision of consumer credit protection laws.

The BCC be authorized:

(1) to require state and Federal agencies engaged in supervising institutions which grant consumer credit to submit such written reports as the Bureau may prescribe;

(2) to administer oaths;

(3) to subpoena the attendance and testimony of witnesses and the production of all documentary evidence relating to the execution of its duties;

(4) to intervene in corporate mergers and acquisitions where the effect would be to lessen competition in consumer credit markets, to include but not be limited to applications for new charters, offices, and branches;

(5) to invoke the aid of any district court of the United States in requiring compliance in the case of disobedience to a subpoena or order issued;

(6) to order testimony to be taken by deposition before any person designated by the Bureau with the power to administer oaths, and in such instances to compel testimony and the production of evidence in the same manner as authorized under subparagraphs (3) and (5) above.

Credit Insurance (Chapter 5)

The Commission recommends that:

The finance charge earned by credit grantors should be sufficient to support the provision of the credit service. The finance charge should not subsidize the credit insurance service. Nor should the charge for credit insurance subsidize the credit operation.

The proposed Bureau of Consumer Credit in the Consumer Protection Agency make a study to determine acceptable forms of credit insurance and reasonable levels of charge and prepare recommendations.

The states should immediately review charges for credit insurance in their jurisdictions and lower rates where they are excessive.

Creditors offering credit life and accident and health insurance be required to disclose the charges for the insurance both in dollars and cents and as an annual percentage rate in the same manner as finance charges and annual percentage rates of finance charges are required to be disclosed under the Truth in Lending Act and regulation Z.

Rates and Availability of Credit (Chapter 7)

Although the Commission makes no generally applicable recommendation concerning branch banking because conditions can vary among the states, it does recommend that where statewide branching is allowed, specific steps be taken to assure easy new entry and low concentration. Such steps would:

1. Give preferential treatment wherever possible to charter applications of newly forming banks as opposed to branch applications of dominant established banks.
2. Favor branching, especially the de novo branching, whether directly or through the holding company device when such branching promotes competition. Banking regulators should exercise a high degree of caution in permitting statewide branching whether directly or through the holding company device when such branching decreases competition or increases economic concentration.
3. Encourage established banks and regulatory agencies to see that correspondent bank services be made available (for a reasonable fee) to assist newly entering independent banks, including the provision of loan participation agreements when needed.
4. Disallow regional expansion by means of merger and holding company acquisitions when such acquisitions impair competition, recognizing that statewide measures of competition are relevant.

The Commission recommends, as did the President's Commission on Financial Structure and Regulation, that under prescribed conditions savings and loan associations and mutual savings banks be allowed to make secured and unsecured consumer loans up to amounts not to aggregate in excess of 10 percent of total assets.

The Commission recommends that the only criterion for entry (license) in the finance company segment of the consumer credit market be good character, and that the right to market entry not be based on any minimum capital requirements or convenience and advantage regulations.

The Commission recommends that direct bank entry in the relatively high risk segment of the personal loan market be made feasible by:

(1) Permitting banks to make small loans under the rate structure permitted for finance companies;

(2) Encouraging banks to establish de novo small loan offices as subsidiary or affiliated separate corporate entities. Regardless of corporate structure these small loan offices, whether corporate or within other bank offices, should be subject to the same examination and supervisory procedures that are applied to other licensed finance companies;

(3) Exempting consumer loans from the current requirement that bank loan production offices obtain approval for each loan from the bank's main office; and

(4) Prohibiting the acquisition of finance companies by banks when banks are permitted to establish de novo small loan offices.

The Commission recommends that existing regulatory agencies disallow mergers or stock acquisitions among any financial institutions whenever the result is a substantial increase in concentration on state or local markets.

The Commission recommends that inter-institutional acquisitions be generally discouraged even though there is no effect on intra-institutional concentration.

The Commission recommends that state regulatory agencies and legislatures review the market organization of their respective financial industries after a 10-year trial period of earnest implementation of the recommendations on market entry and concentration.

If, despite these procompetitive efforts, such a review discloses an inadequacy of competition—as indicated, say, by a continuing market dominance by a few commercial banks and finance companies or the absence of more frequent entry--then a restructuring of the industry by dissolution and divestiture world probably be appropriate and beneficial.

The Commission recommends that antitrust policy, both Federal and state, be alert to restrictive arrangements in the credit industry. Any hint of agreement among lenders as to rates, discounts, territorial allocations and the like must be vigorously pursued and eliminated.

The Commission recommends that each state evaluate the competitiveness of its markets before considering raising or lowering rate ceilings from present levels. Policies designed to promote competition should be given the first priority, with adjustment of rate ceilings used as a complement to expand the availability of credit. As the development of workably competitive markets decreases the need for rate ceilings to combat market power in concentrated markets, such ceilings may be raised or removed.

Discrimination (Chapter 8)

The Commission recommends that:

States undertake an immediate and thorough review of the degree to which their laws inhibit the granting of credit to creditworthy women and amend them, where necessary, to assure that credit is not restricted because of a person's sex.

Congress establish a pilot consumer loan fund and an experimental loan agency to determine whether families whose incomes are at or below the Federal Guideline for Poverty Income Levels issued annually by OEO have the ability to repay small amounts of money which they may need to borrow.

$1.5 million be appropriated for an experimental low income loan program to be allocated among operating expenses, loss write-offs, and loan extensions according to guidelines developed by an advisory committee to the Bureau of Consumer Credit.

There be continued experimentation by private industry in cooperation with Federal, state, and local governments to provide credit to the poor.

Legislation permitting "small small" loans should be encouraged as a suitable means of providing loans to the poor from regulated, licensed lenders.

Federal Chartering (Chapter 9)

The Commission recommends that Federal chartering of finance companies be held in abeyance for 4 years while two complimentary courses of action are pursued: (1) efforts should be undertaken to persuade the states to remove from existing laws and regulations anticompetitive (and by extension, anticonsumer) restrictions on entry and innovation and, (2) Congress should sustain the research initiated by the Commission.

If the substantive portions of the Commission's recommendations regarding workably competitive markets are not enacted within 4 years and states have not eliminated barriers to entry, the Commission recommends that Congress permit Federal chartering of finance companies with powers to supersede state laws in three basic areas which sometimes severely limit competition in availability of credit: limitations on entry, unrealistic rate ceilings, and restraints on amounts and forms of financial services offered consumers.

Disclosure (Chapter 10)

The Commission recommends that:

The Board of Governors of the Federal Reserve System regularly publish a statistical series showing an average (and possibly a distribution) of annual percentage rates for at least three major types of closed end consumer instalment credit: new automobiles, mobile homes, and personal loans.

The Truth in Lending Act should be further amended to require creditors who do not separately identify the finance charge on credit transactions involving more than four instalments to state clearly and conspicuously in any advertisement offering credit: "THE COST OF CREDIT IS INCLUDED IN THE PRICE QUOTED FOR THE GOODS AND SERVICES."

The Truth in Lending Act be amended to make clear the presumption that all discounts or points, even when paid by the seller, are passed on to the buyer and hence must be included in the finance charge.

Section 106(e) of the Truth in Lending Act be amended to delete as excludable from the finance charge the following items numbered in accordance with that paragraph:

(5) Appraisal fees
(6) Credit reports

A full statement of all closing costs to be incurred be presented to a consumer prior to his making any downpayment. In any case, a full statement of closing costs should be provided at the time the lender offers a commitment on a consumer credit real property transaction or not later than a reasonable time prior to final closing.

Section 104(4) of the Truth in Lending Act which exempts public utility transactions from disclosure requirements be repealed.

Creditors be required to disclose the charge for credit insurance both in dollars and as an annual percentage rate in the same manner as the finance charge is required to be disclosed. Additionally, where credit insurance is advertised, that the premium be required to be expressed as an annual percentage rate.

Exempted transactions (Section 104) of the Truth in Lending Act should include credit transactions primarily for agricultural purposes in which the total amount to be financed exceeds $25,000, irrespective of any security interest in real property.

Creditors offering open end credit be permitted to advertise only the periodic rate and the annual percentage rate.

Where terms other than rates are advertised, only the following terms be stated in the advertisement:

Closed end credit	Open end credit
The cash price or the amount of the loan as applicable.	
The number, amount, and due dates or period of payments scheduled to repay the indebtedness if the credit is extended.	The minimum periodic payment required and the method of determining any larger required periodic payment.
The annual percentage rate, or the dollar finance charge when the APR is not required on small transactions.	The method of determining the balance upon which a finance charge may be imposed.
	The periodic rate(s).
	The annual percentage rate(s).

Sections 143 and 144 of the Truth in Lending Act be amended to make clear that there may be no expression of a rate in an advertisement of closed end credit other than the annual percentage rate as defined in the Truth in Lending Act and regulation Z.

Legislation be adopted to permit private suits seeking injunctive relief to false or misleading advertising.

The Truth in Lending Act be amended to provide that the Act and regulation Z apply to oral disclosures.

State laws which are inconsistent with the Federal Truth in Lending Act or which require disclosures which might tend to confuse the consumer or contradict, obscure, or detract attention from the disclosures required by the Truth in Lending Act and regulation Z be preempted by the Federal law.

The Truth in Lending Act be amended as necessary to assure that subsequent assignees are held equally liable with the original creditor when violations of the Truth in Lending Act are evident on the face of the agreement or disclosure statement; and that there be equal enforcement by all appropriate agencies of this provision concerning assignees and all other Truth in Lending Act provisions in order to assure equal protection to all consumers.

Both suggestions of the Board of Governors of the Federal Reserve System pertaining to class action suits and the clarification of the definition of "transactions" be adopted.

The Commission supports the recommendation of the Board of Governors of the Federal Reserve System that Congress amend the Truth in Lending Act specifically to include under Section 125 security interests that arise by operation of law.

The Commission supports the recommendation of the Board of Governors of the Federal Reserve System that Congress amend the Truth in Lending Act to limit the time the right of rescission may run where the creditor has failed to give proper disclosures.

Education (Chapter 11)

The Commission recommends that:

Congress support the development of improved curricula to prepare consumers for participation in the marketplace, with adequate attention to consumer credit as one aspect of family budgeting.

Appropriate Federal and state agencies should continue their emphasis on adult education for low income consumers, try to reach more of them, and develop useful programs for the elderly.

Federal resources be used to encourage expanded research and carefully monitored pilot projects to generate and test new ideas in adult consumer education.

Business organizations support and encourage nonprofit credit counseling, provided it is conducted for the benefit of the consumer and does not serve solely or primarily as a collection agency.

If private debt adjusting services are allowed to continue, their activities be strictly regulated and supervised, including their fees and advertising.

Counseling be made a mandatory requirement for obtaining a discharge in both Chapter XIII and straight bankruptcy, unless the counselor in a particular case should determine that counseling would be unnecessary or futile.

The Future of Consumer Credit (Chapter 12)

The Commission recommends that legislation be enacted to achieve the following goals:

(1) Each consumer's complaint should be promptly acknowledged by the creditor.

(2) Within a reasonable period of time a creditor should either explain to the consumer why he believes the account was accurately shown in the billing statement or correct the account.

(3) During the interval between acknowledgment of the complaint and action to resolve the problem, the consumer should be free of harassment to pay the disputed amount.

(4) The penalties on creditors for failure to comply should be sufficiently severe to prompt compliance.

The Commission recommends additional Federal and state legislation specifically prohibiting any regulatory agencies from establishing minimum merchant discounts.

The Commission also recommends that studies be undertaken now to consider the eventual Federal chartering and regulation of credit reporting agencies, both to assure the accuracy and confidentiality of their credit information and to achieve open and economical access to their data.

Chapter 1

AN OVERVIEW OF THE STUDY AND SOME CONCLUSIONS

Congress instructed this Commission to study and appraise the functioning and structure of the consumer finance industry as well as consumer credit transactions generally. More specifically, it directed the Commission to report on the adequacy of existing arrangements to provide consumer credit at reasonable rates, the adequacy of existing supervisory and regulatory mechanisms to protect against unfair practices and ensure the informed use of consumer credit, and the desirability of Federal chartering or other Federal regulatory measures.

These assignments dictated the general structure of the Commission's research program and set the framework for its report. Not until the three areas of inquiry had been fully explored could the Commission be in a position to appraise the functioning and structure of the consumer finance industry as well as consumer credit transactions generally.

Chapter 2 traces the development of the consumer credit industry in the United States and outlines the structure of the market as it now exists. This chapter points up the magnitude and importance of the consumer credit industry both as the lubricant which oils the wheels of our great industrial machine and as the vehicle largely responsible for creating and maintaining in this country the highest standard of living in the world. It is in this context that the rest of the report is cast—building an environment of urgency to improve the industry which enables U.S. citizens to obtain many necessities and enjoy life's amenities out of current income.

Early in the Commission's research program it became apparent that creditors' remedies and collection practices had a direct, personal impact on consumers and on the price and amount of credit available. Illegal and unconscionable collection practices are instruments of economic and social oppression. However, a dearth of legitimate collection tools results in higher costs, leading to higher rates and reduced availability at the margin. Chapter 3 discusses the Commission's findings related to creditors' remedies and collection practices, assesses their effect on the supply of credit at reasonable rates, and contains recommendations designed to protect the public from unfair practices.

Even the most sophisticated statutory and regulatory schemes avail nothing if they are not adequately enforced. Chapter 4 reviews the supervisory capabilities of various Federal agencies with administrative authority over grantors of consumer credit and state agencies with similar responsibilities. Recommendations in this area are designed not only to improve supervision and examination functions as presently structured but also to rearrange those functions where necessary to eliminate unproductive duplication of effort and provide more uniform and effective supervision and enforcement of consumers' rights under law. The chapter focuses on improving supervisory and regulatory mechanisms to protect the public from unfair practices.

Chapter 5 examines one component of the consumer credit offer function found in most consumer credit transactions—credit life, accident, and health insurance. Its ascendency is a relatively recent phenomenon. Such insurance is packaged and sold with consumer credit and, as a practical matter, is available only from the creditor. Is it being thrust on the unwary consumer? Should the cost of credit insurance be made known to the consumer in much the same way that Truth in Lending requires the finance charge to be disclosed—as an annual percentage rate (APR)—so that it may be readily compared among transactions? These and other questions come under scrutiny in Chapter 5. Recommendations in this area are designed to help consumers avoid the uninformed use of consumer credit.

In Chapter 6 the history of rate setting from ancient times is reviewed and some major reasons advanced for legislating maximum finance charges on consumer credit are examined in the context of historical experience. Chapter 6 seeks to answer the question almost as old as mankind: do rate ceilings really protect the consumer?

Inextricably bound up with rates is the matter of availability, and Chapter 7 examines factors involved in determining the price of consumer credit as well as its availability. This chapter summarizes findings from the

Commission's mid-1971 survey of the amount and price of consumer credit in each state and compares the findings across states. From this empirical evidence the Commission is able to draw conclusions about the effects of operating costs and competition on the price of consumer credit and the effects of rate ceilings and competition on the availability of consumer credit.

In Chapter 8 discrimination—race, sex, economic status—in the granting of credit is examined. Recommendations here and in Chapter 6 go to the very heart of the first specific assignment from Congress: the adequacy of existing arrangements to provide consumer credit at reasonable rates.

The second specific Congressional charge—to report on the adequacy of existing legal mechanisms to insure the informed use of consumer credit—is the point of departure for Chapter 10, which deals with disclosure under the Truth in Lending Act. Here the Commission seeks to determine whether Truth in Lending is doing its job. Are consumers aware of APR's and other credit terms? Are consumers avoiding the uninformed use of credit? Finally, Chapter 10 examines problem areas which the Commission perceives to exist and suggests improvements to eliminate barriers to awareness of consumer credit terms which inhibit the informed use of credit.

Closely allied with the subject of disclosure and the Commission's recommendations to make disclosure more effective are education and information. Chapter 11 reviews existing consumer education programs and their particular concern or lack of concern with credit—in elementary and secondary schools, in colleges and at the adult education level. If consumers do not know what is required to be disclosed to them in connection with consumer credit transactions, or what the APR and other disclosures mean and how they may be used, they cannot effectively shop for the best credit "buy" or avoid the uninformed use of credit. Recommendations in this chapter are an extension of those developed in the preceding chapter.

The third specific mandate from Congress directs the Commission to report on the desirability of Federal chartering of consumer finance companies, and Chapter 9 addresses itself to that task. The whole concept of Federal chartering of nondeposit consumer finance companies is a novel and challenging one, and this chapter discusses its "pros" and "cons." Rather than recommendations, the Commission offers guidelines for the Congress to consider in determining the proper role of, and when to resort to, federally chartered finance companies.

Chapter 12 takes a look into the future. This chapter plots the likely developments in the consumer credit industry, including an assessment of the importance of the almost inevitable electronic funds transfer system (EFTS) and its companion, on-line electronic credit authorization. Recommendations focus particularly on the operation of these systems—the concern being twofold: (1) that both systems be open to all grantors of consumer credit, and (2) that the systems not be managed, manipulated, or otherwise used as instruments for invasion of the privacy of consumers involved with the system.

It remains then for the Commission to *appraise* the functioning and structure of the consumer finance industry, as well as consumer credit transactions generally. Naturally, this appraisal is based on studies which the Commission conducted and commissioned, and is covered in detail in later chapters of this report.

As Congress recognized, such an appraisal must begin (and end) with the issue of whether the industry provides adequate consumer credit to those who want it at reasonable rates. Unfortunately, the Commission has been able to devise no empirical method for determining who should get credit, how much credit, what kind of credit, and at what price.

It is questionable whether legislators want to begin making the intricate social judgments involved in designing laws to spell out who should get what kind of credit, how much, and at what rate. Most legislators attempt at all times to represent the best interests of their constituents. But their expertise is in the field of laws and statutes, not in rulemaking and regulations required to specify what part of a family's income could safely be devoted to monthly payments on credit obligations—given such variables as size of family, age of wage earners, nature of employment, and so on. This is the kind of activity the industry itself is constantly working on and attempting to improve by means of its credit scoring systems. The profit motive should be strong enough in our economy to assure that credit grantors will try to make as much credit available as possible at "fair" prices and that if one creditor's "blind spot" keeps him from extending credit to a creditworthy individual, another creditor will probably jump at the chance.

This does not mean that there is no role for the legislator in the area of consumer credit. There are critical functions—namely: (1) to promote and assure the maintenance of what the Commission deems to be the key ingredient of a finance industry capable of providing an adequate supply of credit at reasonable rates—competition among numerous alternate sources of credit; (2) to assure access *by all* to these alternate sources of credit; and (3) to prevent excesses which the "system" may invoke against the borrower.

To expand these functions we note: in our economy, concededly the most successful type yet developed, consumer credit has played a vital role. It has done so, moreover, by growing, like Topsy, on its own. It has

adjusted to differing times, economic needs, consumer goods, geographical distinctions, and so on with a minor amount of tinkering on the part of the government. Such tinkering as governments have engaged in has been of a negative variety tending to restrain and restrict. But even given government interference (not assistance), the consumer finance industry through the play of market forces—competition—has provided a great number of Americans with consumer credit at rates to which they apparently do not object, for they come back for more.

As already noted, the Commission cannot judge whether all have obtained "all" the credit of the "type" they wanted, that they were "entitled" to, at a "fair" rate. Nor can it say that the price of hamburger or shoes was "fair" at any given time, or that more of either might be better. In almost all instances in our economic system, we look toward a marketplace. If sufficient alternative sources compete for patronage, it is assumed that the price and supply are "fair", because they are set by free competitive forces.

The Commission perceives no reason to assume that—in general—competition will not have the same result in the consumer credit area. Its principal assessment of the consumer credit system is therefore that the essentials of how much credit, to whom, and at what price should be left to the free choice of consumers in the marketplace—provided that that marketplace is competitive. The primary role of legislation and regulation should be to promote and assure the maintenance of real competition in the form of numerous alternate sources of supply of a variety of forms of consumer credit.

As already noted, if anything, state legislation especially has tended to restrain competition and unnecessarily segment the consumer credit market. Succeeding chapters in this report will demonstrate how many of the existing laws and regulations tend to inhibit competition in the granting of credit. They consist of unrealistic rate structures including restrictions on the size and maturities of certain types of loans; convenience and advantage statutes and other licensing laws which operate to restrain free access to the credit granting market; laws which promote segmentation of the supply side of the market such as "brick wall" and similar provisions which limit the ability of retailers and other types of firms from making on-premise cash loans; statutes which prohibit savings and loan associations, mutual savings banks, and life insurance companies from making consumer loans; restrictions which prevent banks from availing themselves of small loan rates; and other limitations on inter- and intra-state branch banking.

The Commission urges, therefore, that legislators begin to remove these impediments to competition and this segmentation of consumer credit suppliers in order to achieve, insofar as is consistent with other policies, the broadest penetration by all credit grantors in all fields of consumer credit. This will assure the consumer access to a variety of credit sources and types of credit and, consequently, of the benefits of a competitive marketplace.

The Commission would further urge that antitrust policy enforcers, both Federal and state, be particularly alert to the dominance of consumer credit markets by a few firms, to barriers to entry, and to restrictive arrangements in the credit industry. Of particular concern are bank holding companies' acquisitions in related consumer credit fields (small loan companies, for example) which reduce the number of creditors in many markets and eliminate competition and potential competition between the acquiring bank and small loan companies. The Commission would opt, instead, for providing direct bank access to the small loan market by eliminating restrictive legislation. Perhaps in such instances, toehold acquisitions might be countenanced in separate geographical areas but this obviously will depend on a variety of circumstances. Of course, any hint of agreement among lenders as to rates, discounts, territorial allocations and the like must be vigorously pursued and eliminated. Further, such antitrust policy should not be the exclusive province of Attorneys General charged with enforcement but should be the underlying principle of regulatory agencies supervising various aspects of the consumer credit market such as the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, state banking agencies, and so on. The Commission recognizes that insofar as those agencies are concerned, consumer credit may be but one function of institutions subject to their regulation and that their ultimate decision must be based upon many interrelated considerations. Nonetheless, no harm will be done to current supervisory responsibilities if competition for consumer borrowers is adopted as a policy guideline to be factored into ultimate judgments. The Commission urges that adoption.

As in any other field of endeavor, the Commission recognizes that in this country we do not have a total *laissez-faire* economy. To the degree that there is adequate competition, the government will generally leave that field alone, subject to important qualifications: conflict with other policy considerations; elimination, in the interests of the public, of excesses in the marketplace; or, to put it another way, protection of the consuming public from practices deemed unfair or unwise. This, then, is the second area for legislative and regulatory concern—the elimination or modification of practices in the consumer credit field deemed unduly harsh or otherwise inappropriate—such as certain collection practices, billing practices, and credit information practices. However, legislators should be aware of proposals disguised as measures to "protect" consumers,

such as "brick wall" provisions and licensing requirements, which are really intended to protect industry from the goad of competition.

Further, to assure that competition is meaningful, the legislator and the regulator must be vigilant in providing the basis for the consumer's "right to know." While Truth in Lending is a giant step in this direction, it should continuously be monitored and assessed for potential improvements.

Underlying the Commission's belief that competition is the best regulator of the consumer credit marketplace is its belief that a competitive system cannot be "half free." If there is to be competition, then it follows that such competition should also be the governor of *rates* as well as other aspects of credit granting (amount, type, and so forth). It would be inconsistent to turn to the industry and attempt to regulate and eliminate practices which affect operating costs but at the same time limit the rate by fiat so that it cannot seek its own level. And yet this is precisely what legislators have done. For example, the effective elimination of some creditors' legal collection devices increases bad debt and collection expenses. When such elimination is not accompanied by a rate structure which recognizes and allows for those increased costs to be covered, less credit is available than would be at equilibrium conditions. The Commission recommends a consistent approach. If there is to be free access, open competition, and elimination of harmful or inappropriate practices, then *inhibiting* rate ceilings should be reviewed and revised to allow competitive forces to operate.

Finally, the Commission fails to see why every citizen of the United States is not entitled to qualify for participation in some part of the credit system herein advocated. It can find no validity in the proposition that when the legislature of a particular state refuses to move away from anachronistic notions, its citizens should suffer deprivation of credit afforded others of equal standing. Accordingly, the Commission urges as its first choice the adoption of state laws designed both to assure fair treatment of all consumers and to give all credit grantors equal opportunity to compete. Failing this, the Commission's second choice is to urge Federal legislation to accomplish this goal. Enforcement, however, is too broad to assign other than to the states, perhaps with Federal monitoring.

In this connection the Commission notes that state as well as Federal enforcement of laws dealing with consumer credit has been uneven at best, and that definite improvement is called for. Passage of laws ultimately left in desuetude is no help to borrowers or creditors.

The foregoing, then, constitutes the Commission's overall recommended legislative and regulatory approach: removal of impediments and barriers, manmade and statemade, to the operation of competitive forces, proposals to assist vigilant legislatures and regulators to combat monopoly and restrictive practices, elimination of market excesses, and continued efforts to assure that the consumer will have full knowledge of his credit transactions, thereby permitting rates to be set by workable competition in the marketplace.

This goal cannot be achieved overnight, but the Commission is persuaded that it can be achieved within a reasonable period of time.

Chapter 2

DEVELOPMENT AND STRUCTURE OF CONSUMER CREDIT

DEVELOPMENT OF CONSUMER CREDIT

Consumer credit is not a 20th century phenomenon in the United States; it was an accepted fact of life in the early Colonies. The image of the sturdy, self-reliant, resourceful pioneer who always paid cash for his staples and his tools may be the one imparted by some accounts of early colonial life, but it is not entirely accurate. Retail credit was available to farmers on a crop-to-crop basis. When they were short on cash, they did as many consumers do today–they traded their expectations of future income for goods and services from local merchants. Generally, merchants levied no direct finance charge, but the cost of credit was built into the price of the merchandise. Furniture was often sold on the instalment plan. One writer reports that over nine-tenths of the sales of David Evans, colonial cabinet maker, were made on credit.[1] Pianos, books, and sewing machines were sold on the instalment plan around the middle of the 19th century. Although automobiles had been produced earlier, they were not sold on the basis of monthly payments until about 1910.[2] The rapid growth in the credit sale of automobiles provided the basis for both the mass market necessary to their economical production and a remarkable increase in the volume of consumer credit.

Because the usury laws that the Colonies had inherited from England prevented the granting of cash loans at economically feasible rates, a legal instalment loan market was, in essence, outlawed. Since the need for small cash credit nonetheless existed, a flourishing illegal market developed. "By 1900, almost every large city in America had its loan companies, all operating illegally as to the rate of interest and with the interest rates covering a high and wide range . . . ."[3] The studies of the Russell Sage Foundation disclosed that the rates of charge of well over 200 percent per annum in the illegal market were often accompanied by harsh collection tactics.[4] As a result of those studies a model bill known as the Uniform Small Loan Law was drafted to provide an exception to the usury law so that consumers could obtain small amounts of legal cash credit at conscionable rates. Initially, the rate ceiling on small cash loans (up to $300) was fixed at 42 percent per year.

The development of credit unions (1909) and Morris Plan banks (1910) began shortly before the establishment of licensed cash lenders. As will be seen later, credit unions have become an increasingly important source of credit for consumers. Morris Plan banks paved the way for commercial banks to enter instalment lending and became virtually indistinguishable from those banks whenever they were given the privilege of accepting demand deposits.

Reasons for growth of consumer credit

Between the ends of 1950 and 1971, consumer credit outstanding rose from $21.5 billion to $137.2 billion, an increase of over five times–and a compound annual rate of growth of over nine percent. To give perspective to this growth it may be noted that over the same period outstanding nonfarm mortgages rose about five times, corporate debt 4 1/2 times, and farm debt, about four times. Primarily as a result of the slower rate of growth of net public debt, which only doubled, consumer credit grew from 4.4 percent to 6.9 percent of net public and private debt between 1950 and 1971. The reasons for this increased use of consumer credit may be found in the natural adaptation of consumer and business to changes in the ability and willingness of consumers to incur debt, as well as to a continued shift towards the ownership of assets.

Characteristics of consumers. Consumers' ability to assume obligations to repay debts depends in part upon the expected size and variability of their incomes. Of particular influence is consumers' "discretionary income," that is, the income over and above that required for necessary expenditures on food, clothing, and shelter. Although there is no universally acceptable measure of its level, some indication of the dramatic change that has occurred in the past 21 years may be gained by observing shifts in family incomes in constant

dollars. Whereas not quite half the families in 1950 had incomes of $5,000 or more in terms of 1971 dollars, some 21 years later over four-fifths of families had such incomes. The number of families with incomes of $5,000 or more (1971 dollars) almost doubled from 23.2 million to over 43.5 million.[5] Not only was real income higher, but it was also more stable as a result of such developments as unemployment benefits and various forms of health insurance.

Another factor that encouraged consumers' use of credit was the increased urbanization of the population. Whereas over 15 percent of the total population was on farms in 1950, less than 5 percent was in 1970. A greater dependence on money incomes, coupled with the typical needs of urban dwellers, probably contributed to a greater dependence on credit, both to finance the urban life and to cushion the variability in money incomes. It should be noted, however, that the widespread availability of television has probably brought a greater uniformity in life styles among farm and urban consumers. Thus their needs and desires for consumer credit probably differ much less now than they did in the years prior to 1950.

The increased use of credit is also explained in part by the changing age distribution of the population. Young married consumers are heavy users of credit. At that stage in their life cycle their needs exceed their current incomes. Consumer credit permits them to pay for purchases to meet such needs out of future income. Between 1950 and 1971, the number of individuals aged 18 to 24 years grew from 18.6 million to 28.2 million.[6] In contrast to this 50 percent increase, the number of individuals in all other age brackets grew by only 33 percent. During this time many of these young people were buying their first car, as well as their first crib and playpen. The increased demand for credit was derived primarily from the demands for goods and services by a burgeoning crop of young Americans.

Willingness to incur debt. A need or demand for credit does not necessarily lead to the granting of credit. The increased willingness of consumers to use credit has resulted from an interaction of consumer and credit grantors. On the one hand, consumers became more willing to use credit, in part as a result of their higher and more stable incomes and in part because the growing youthful portion of the population accepts credit as an economic tool more readily than the older generation. On the other hand, the credit industry responded to consumers' acceptance of credit by creating new and often more useful forms of instalment credit. Thus Wanamakers in Philadelphia pioneered the retailer's adoption of revolving charge accounts as early as 1938, and the Franklin National Bank was the first to offer a bank charge-card plan in New York in 1951. Check-credit plans were developed by the First National Bank of Boston in the mid-1950's to provide cash credit on a revolving basis. These new forms of credit not only made more credit available, but offered it more conveniently on a continuing basis, thus obviating the need to reapply for each extension of credit.

Shift to asset ownership. Consumers added substantially to their ownership of durable consumer goods through their use of credit during the past two decades. The level of personal consumption expenditures on durable goods almost tripled from 1950 to 1970, while total expenditures were 3.2 times higher in 1970 than in 1950. However, it is necessary to keep in mind that prices of durable goods have risen much less rapidly than prices of nondurables and services. Over the 20-year period prices of durable goods rose 26 percent; prices of nondurable goods (excluding food) rose 48 percent; and prices of services rose a thumping 107 percent. Consequently, the relative extent to which consumers have accumulated durable goods in real terms has been obscured by the much greater inflation in prices of nondurable goods and services.

An important reason for the shift to asset ownership during the past two decades has been the increase in ownership of homes—in themselves assets—although the credit used to acquire homes is not counted statistically as part of consumer credit. In large part as a result of government support of housing, the percentage of owner-occupied homes rose from 55 percent in 1950 to over 64 percent in 1970. Since home ownership was also accompanied by a suburbanization of the population, this trend brought with it needs for credit to purchase the equipment necessary to suburban home ownership—refrigerators, washing machines, lawn mowers, playpools, and often, a second car. Within the last 11 years the proportion of households owning two or more cars jumped from about 16 percent to just under 30 percent.[7]

The shift to asset ownership also reflects a decision by consumers to substitute the use of consumer-owned capital goods for the use of commercially-owned capital goods. Thus the purchase of an automobile substituted, perhaps unfortunately, for daily fares on street cars and buses, the home washing machine and dryer for payments at the laundromat, and the television set for the admission price to movies and other forms of entertainment. Even if the auto or appliance were purchased on credit, the monthly instalments paid for it over a much shorter interval than the period of time over which services were received. In addition, quite often consumers also gained significant returns on their investment. A study prepared for the Commission shows annual rates of return from ownership of a washer and dryer ranging

from 6.7 percent (three loads per week) to 29.0 percent (seven loads per week).[8]

Finally, the trend to asset ownership was aided by the movement of women into the labor force. This shift, as well as desires for increased leisure time, brought a demand for labor-saving devices in the home. Freeing the housewife from the kitchen and the laundry room for recreation and employment thus increased the use of credit for automatic dishwashers, self-timing ovens, washers, dryers and other home appliances.

TYPES OF CONSUMER CREDIT

In reviewing statistics on consumer credit published by the Board of Governors of the Federal Reserve System (FRB) and relating them to issues in state and Federal legislation governing consumer credit, one should note some conceptual and definitional differences between the statistics and legislative coverage. The data provided by FRB may then be classified into instalment and noninstalment credit, as well as into the subclassifications of each.

Statistical and legislative differences

The data on consumer credit provided by FRB include "all short- and intermediate-term credit that is extended through regular business channels to finance the purchase of commodities and services for personal consumption, or to refinance debts incurred for such purposes."[9] However, a number of forms of credit not included in the FRB data are covered by the Truth in Lending Act (TIL) and the Uniform Consumer Credit Code (UCCC). The FRB data do not include consumer lease obligations, whereas TIL includes in the term "credit sale" some contracts in the form of bailments and leases.[10] The UCCC covers "consumer leases" which have terms exceeding 4 months.[11]

Both the TIL and UCCC include agricultural credit in their coverage whereas this is excluded from the FRB's estimates as a form of business credit. Since the FRB's "commercial bank call report data on loans to farmers do not segregate credit for consumption from that for production purposes,"[12] some understatement probably exists in the FRB's statistics of credit received by farmers for personal consumption and to refinance debts incurred for such purposes.

FRB data do not include owner-occupied home mortgages as a form of consumer credit, although credit used to acquire mobile homes is covered. Borrowings under "open-end" mortgages are not treated as a component of consumer credit, even where used for personal consumption. But home repair and modernization loans are included. TIL and the UCCC apply to all residential real estate credit extended to individuals for disclosure and related debtors' remedies. In order to reach the high-rate, second mortgage without at the same time covering home mortgages in general, the other provisions of the UCCC apply to sales of interest in land and loans primarily secured by an interest in land where the finance charge exceeds 12 percent per annum.[13]

In one respect the coverage of the FRB's consumer credit statistics is broader than that of TIL and the UCCC. The FRB data include consumer credit transactions whether or not a finance charge is assessed, but TIL classifies as consumer creditors only those "who regularly extend, or arrange for the extension of, credit for which the payment of a finance charge is required. . . ."[14] Since a finance charge is implicit in an instalment credit transaction, regulation Z, which was promulgated by FRB to implement the Truth in Lending Act, clarifies the coverage by defining consumer credit as credit "for which either a finance charge is or may be imposed or which, pursuant to an agreement, is or may be payable in more than 4 instalments."[15] However, FRB data include credit scheduled to be repaid in *two* or more payments. Finally, the UCCC covers consumer credit sales that are repayable in instalments or for which a credit service charge is made.[16] Thus the FRB data include more consumer instalment credit than covered by TIL in some instances but not in others. For instalment credit, the coverage of the FRB and the UCCC is unaffected by the presence or absence of a finance charge. For noninstalment credit—such as the 30-day charge account and gasoline credit card—data from the FRB include outstandings not covered by either TIL or the UCCC.

Instalment versus noninstalment credit

The FRB's data on consumer credit are first divided between instalment and noninstalment credit. As noted earlier, instalment credit includes all consumer credit scheduled to be repaid in two or more payments. Consumer credit scheduled to be repaid as a single, lump sum is classified as noninstalment credit. The major classification problem in this area is the treatment of retailers' revolving charge accounts. When a consumer exercises his option to pay his account within the "grace period" and thereby avoids a finance charge, he is really treating the account as if it were a traditional 30-day charge account. Although the 30-day charge account is clearly noninstalment credit, the statistical problems of correctly identifying the "noninstalment" portion of revolving charge accounts have forced the FRB to

classify the balance in all such accounts as instalment credit.

Instalment credit comprised four-fifths of consumer credit outstanding at the end of 1970. Over the past two decades instalment credit has grown much more rapidly than noninstalment credit (Exhibit 2-1). Instalment credit outstanding rose by 5.9 times, and noninstalment credit only 2.8 times. The more rapid expansion of instalment credit reflects primarily the shift to asset ownership–the purchase of consumer durables–which is financed more by instalment than by noninstalment credit.

During this period consumer instalment credit outstanding rose more rapidly than monthly payments. While outstanding consumer instalment credit rose by 5.9 times, the annual level of repayments rose by only 4.5 times. This occurred because of the longer maturities that became available, particularly on automobile credit and to some extent on personal loans. A much smaller portion of the differential in growth rates is attributable to the development of various forms of revolving credit which substituted in some measure for noninstalment credit.

Classes of instalment credit. The four classes of instalment credit are automobile paper, other consumer goods paper, home repair and modernization loans, and personal loans (Exhibit 2-2). The largest and most volatile portion of consumer instalment credit is automobile credit, which accounted for about 35 percent of the total outstanding at the end of 1970. Automobile credit includes credit extended for the purchase of both new and used automobiles; other consumer goods paper represents credit extended for the acquisition of such consumer goods as home appliances, boats, and mobile homes. Repair and modernization loans, which have grown only moderately, include both FHA-insured credit and noninsured credit extended to consumers for the maintenance and improvement of their homes. Many personal loans are made to refinance existing debts, while others are used to meet medical, travel, and educational expenses. Undoubtedly some personal loans are used to acquire automobiles and other consumer goods, and to repair and modernize homes. Because the lender does not always know the intended purpose of the loans, some overstatement of personal loans outstanding is likely with a corresponding understatement of outstandings in the other three categories of consumer instalment credit.

Classes of noninstalment credit. The components of noninstalment credit are single-payment loans, nonrevolving charge accounts, and service credit. Most single-payment loans are extended by commercial banks. The charge-account segment includes primarily the traditional 30-day charge accounts of retailers, as well as amounts owed on gasoline credit cards, home heating-oil accounts, and other credit-card accounts. The most important component of *service* credit is debt to doctors and hospitals; a smaller portion is owed to public utilities and other service establishments. Single-payment loans have been the most rapidly growing portion of noninstalment credit.

Holders of consumer credit

FRB classifies amounts of consumer credit outstanding by *holder*–rather than by *originator.* For example, a significant portion of automobile paper is originated by dealers at the point of sale and subsequently sold to banks or finance companies. In such cases the banks and finance companies are classified as the holders of the paper, because they supply the credit.

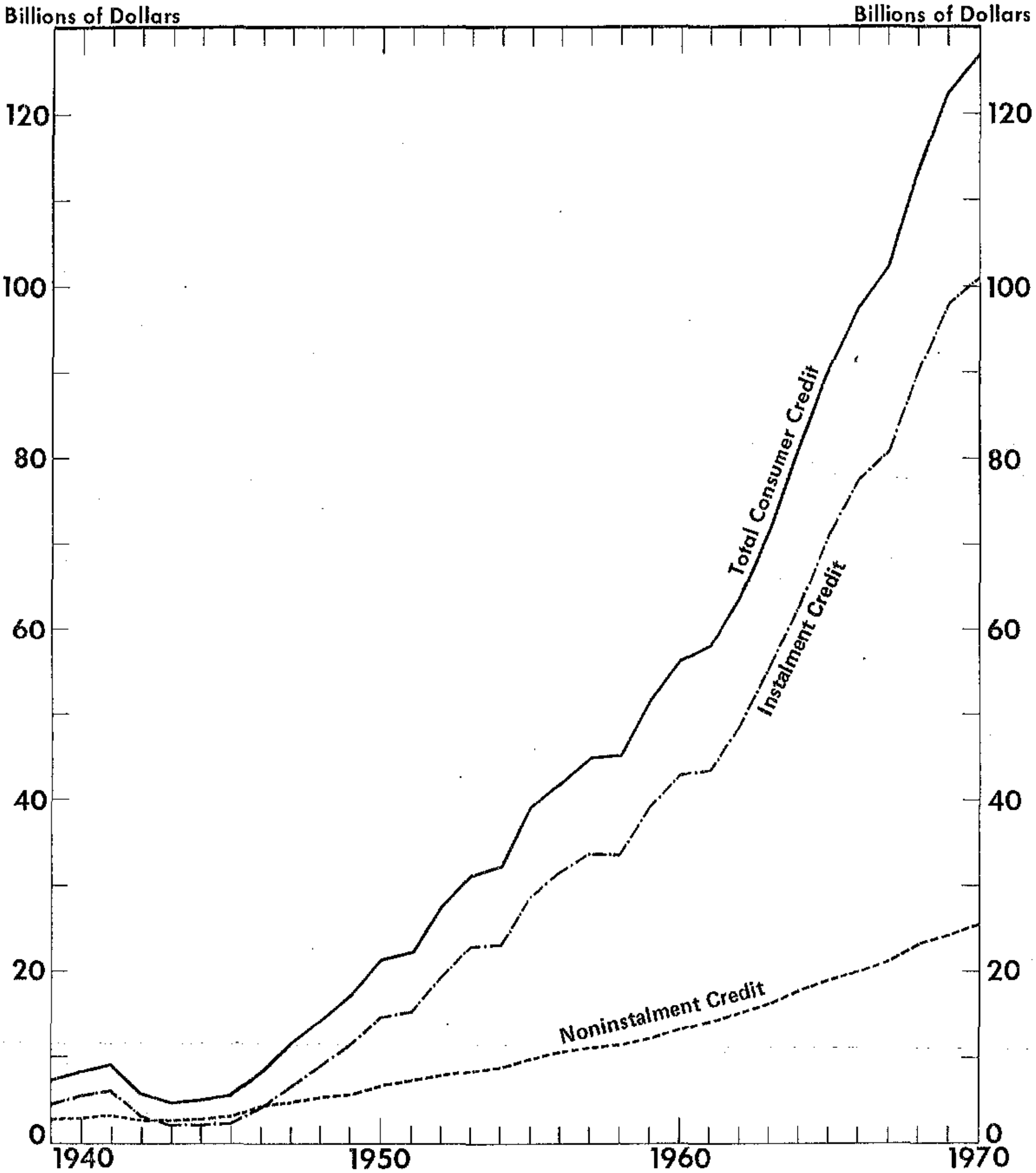
At the end of 1970, some 13,600 commercial banks held just over $50 billion of consumer credit outstanding, or almost two-fifths of total outstandings. Their holdings of consumer instalment credit have grown rapidly in the past 20 years (Exhibit 2-3), although, not as rapidly as those of credit unions. Between 1950 and 1970 commercial banks increased their market share of consumer instalment credit by only two percentage points (Exhibit 2-4). In recent years their growth has been stimulated by the development of bank credit cards, but outstandings on credit cards were still only about 9 percent of banks' holdings of instalment credit at June 30, 1971.

Finance companies for the most part purchase instalment paper arising from retail sales of consumer durables and make cash loans. Until 1971, sales finance and personal finance companies were classified separately by the FRB. However, the distinction between the two has become blurred in recent years as each type of concern has diversified its consumer credit activities. Also, unattractive returns from consumer credit have caused several major firms to divert their resources into nonconsumer credit investments. At mid-1965, about 3,700 finance companies were operating in the United States.[17] This figure, however, greatly understates the competitive impact of these firms, since many had numerous offices. Assuming the same ratio of firms to offices that prevailed in 1960, the number of offices of finance companies would be estimated to be between 13,000 and 14,000.

Adding to competition in the market for consumer credit were some 23,656 credit unions.[18] The effectiveness of their competition is shown in Exhibit 2-4. Between 1950 and 1970 they more than tripled their share of the market, largely at the expense of finance companies and retail outlets. Credit unions, as cooperatives, are not subject to state or Federal income taxes. Many firms provide the credit unions serving their

EXHIBIT 2 - 1

CONSUMER INSTALMENT AND NONINSTALMENT CREDIT OUTSTANDING, 1939-1970



SOURCE: National Commission on Consumer Finance based on FRB data.

EXHIBIT 2 - 2

GROWTH IN MAJOR TYPES OF CONSUMER INSTALMENT CREDIT

1939-1970

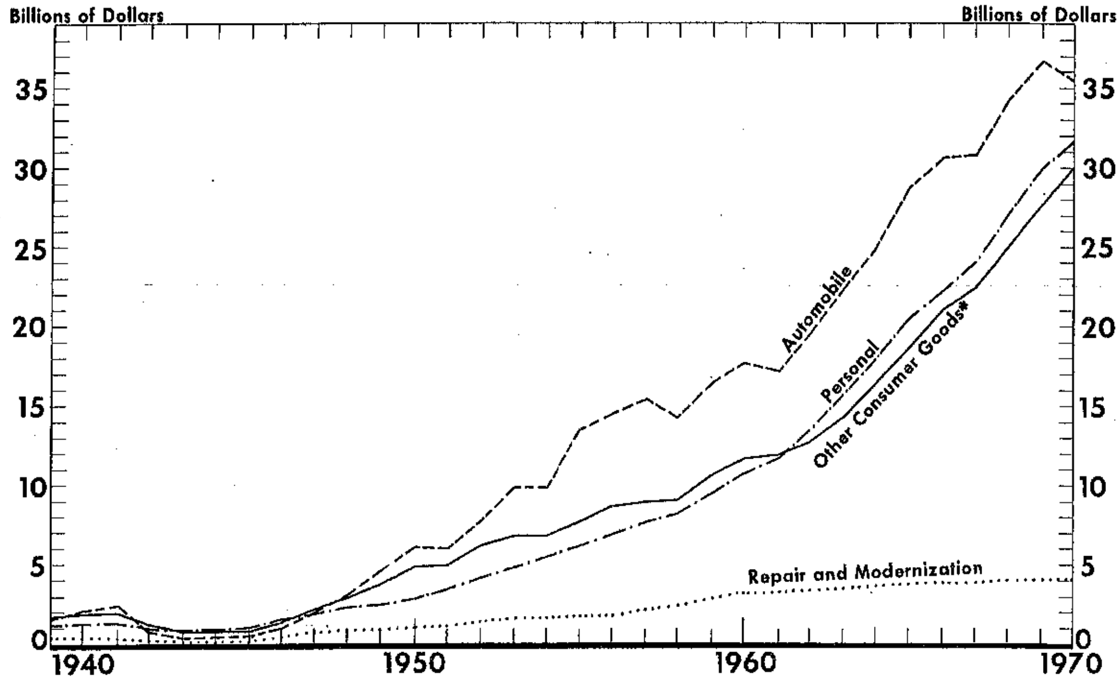
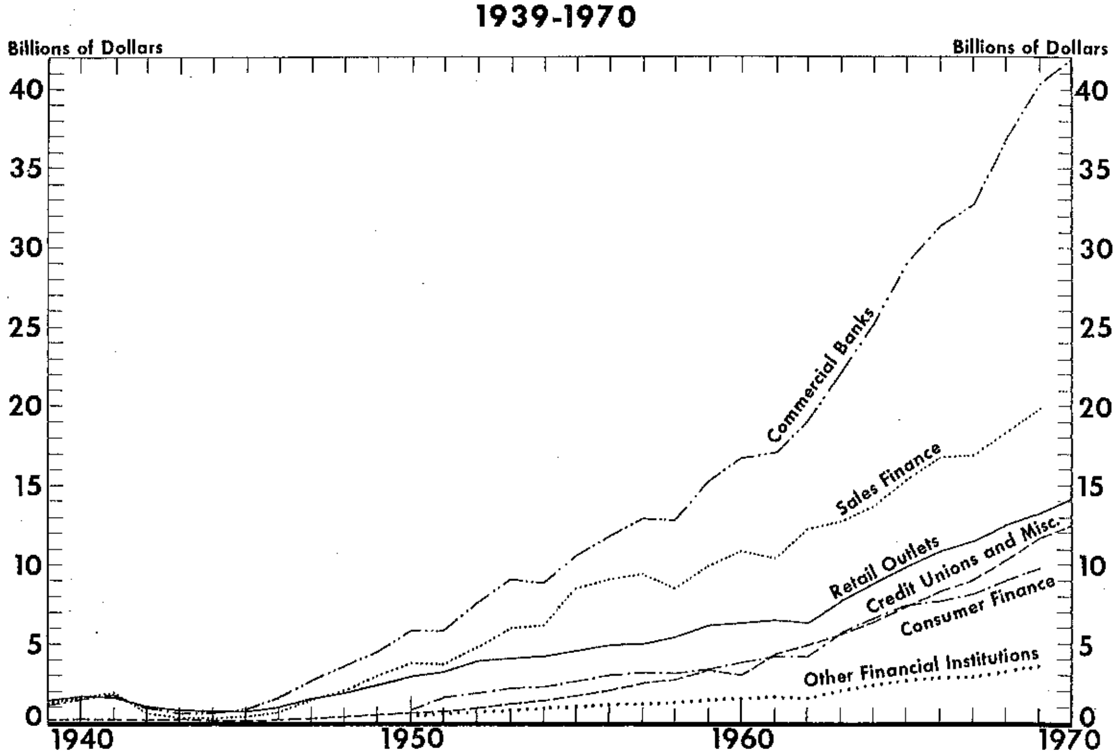


EXHIBIT 2 - 3

INSTALMENT CREDIT OUTSTANDING BY HOLDER

1939-1970



*Not including charge accounts.

SOURCE: National Commission on Consumer Finance based on FRB data.

EXHIBIT 2-4

CHANGES IN HOLDINGS OF CONSUMER INSTALMENT CREDIT BY TYPE OF HOLDER, 1950-1970

	Amounts outstanding (Dollar amounts in millions)			
	December, 1950		December, 1970	
	Amount	*Percent*	*Amount*	*Percent*
Commercial banks	$5,798	39.4	$41,895	41.4
Finance companies	5,315	36.1	31,123	30.8
Credit unions	590	4.0	12,500	12.4
Miscellaneous[a]	102	0.7	1,546	1.5
Retail outlets	2,898	19.7	14,097	13.9
Totals	$14,703	100.0	$101,161	100.0

[a]Miscellaneous lenders include savings and loan associations and mutual savings banks.
Details may not add to totals because of rounding.

Source: Board of Governors of the Federal Reserve System.

employees with office space and equipment at no charge, and many employees contribute their time. Credit unions' lower operating costs and freedom from taxes are transmitted to their members in the form of higher dividends and lower credit charges than provided by many competing credit grantors.

Retail outlets provide the other major source of credit to consumers. They are probably the most numerous credit grantors, although reliable data on the number of firms are not available. Even though retailers shifted some portion of their outstandings from charge accounts to revolving credit, their share of instalment credit outstanding declined from almost 20 percent to less than 14 percent between 1950 and 1970.[19] Their share of noninstalment credit declined even more, from almost half in 1950 to just over one-fourth in 1970.

The existence of many competing credit grantors is essential to providing consumers with adequate amounts of credit at reasonable rates. The very large number of credit grantors in the United States suggests that considerable competition is very likely to be found in the market for consumer credit. To evaluate the extent of competition properly it is important to understand that for the most part there is no national market for consumer credit. Consumers seldom shop for credit outside their town or city, although there is some mail order business, especially in the retail field, and considerable borrowing against cash reserves of life insurance policies. But generally, the market for consumer credit is fairly restricted geographically. Perusal of telephone book "yellow pages" of most cities discloses many competing credit grantors—commercial banks, finance companies, savings and loan associations, industrial banks and loan companies, credit unions, savings banks, and retailers. The competitive nature of these markets is increased where credit grantors have ease of entry into the market and is hampered where restrictive licensing provisions and legal rate ceilings bar the entry of some creditors into the market for higher-risk borrowers.

The generally competitive nature of most markets for consumer credit should not, however, obscure the fact that competition in some markets is probably not entirely effective. Competition is less likely to be effective where markets are highly concentrated—where the largest firms have a commanding share of the market. Also, there is less competition when there are fewer competitors, e.g., in small, so-called, "one-bank" towns and in some areas of the inner cities populated by low income consumers. This report contains recommendations in later chapters for lowering concentration in markets and providing more alternatives for consumers seeking credit.

The changing market shares of various types of consumer instalment credit by the various holders of

that credit are shown in Exhibit 2-5. Commercial banks clearly have assumed a dominant role in the instalment financing of automobiles, holding over 56 percent of total outstandings at the end of 1970. Credit unions have become increasingly important in the automobile loan field. A study of the purpose of loans made by Federal credit unions in 1971 shows that more than 30 percent of the amount of loans made were to finance the purchase of new and used cars.[20]

Retailers' share of other consumer goods instalment credit has declined, while that of sales finance companies has increased over the past two decades. This shift is explained in part by the formation of finance subsidiaries by a number of large manufacturers and retailers, as well as by the increased financing of mobile homes by sales finance companies. There was also a transfer of holdings from retailers to banks. The share of other consumer goods paper held by commercial banks has risen sharply in the past few years because of the accelerated introduction of bank credit cards. At the end of 1967, 390 banks reported holding some $800 million under credit-card plans. But just 3 years later over 1,200 banks reported outstandings on credit cards of $3.8 billion.[21]

Although commercial banks dominate the market, they have held a declining share of home repair and modernization loans outstanding over the past 20 years (Exhibit 2-5). Credit unions and other financial lenders (excluding finance companies) have increased their share of home repair and modernization loans. During 1971, more than 8 percent of the amount of loans extended by Federal credit unions were for home repair and modernization.[22]

The Commission conducted a survey of the major suppliers of consumer instalment credit at mid-1971 in which all such credit then outstanding was classified in seven categories. The results of that survey are summarized in Exhibit 2-6. Commercial banks held the largest portion of outstandings in four of the seven categories and ranked second in the other three. Finance companies' personal loans outstanding exceeded those of commercial banks, and retailers held more revolving credit and other consumer goods paper than did commercial banks.

In the same survey, the Commission gathered data on average customer rates of charge on major types of consumer instalment credit extended, and classified those responses by source. Exhibit 2-7 summarizes average rates charged by commercial banks, mutual savings banks and retailers on typical transactions. For finance companies, the survey sampled actual contracts, and those results are summarized in Exhibit 2-8.

USERS OF CONSUMER CREDIT

As indicated earlier, consumers use credit, not for its own sake, but because they wish to acquire goods and services. Therefore, consumers making above-average use of credit could be expected to be those whose need for goods and services exceed immediately available current income. This general hypothesis is supported by the data in Exhibit 2-9.

With respect to income, families who used credit most frequently in 1971 were those with annual family incomes before taxes of $7,500 to $15,000. Families with incomes of less than $5,000, especially less than $3,000, used instalment credit much less frequently. Either they exercised self-restraint, or credit grantors were unwilling to extend them credit. The frequency of use of instalment credit also declined among families with incomes above $15,000. Some of these families may have used consumer credit, but in the form of single-payment loans from commercial banks or life insurance company policy loans—types of credit not covered by the survey data. Others probably did not require credit because of their wealth.

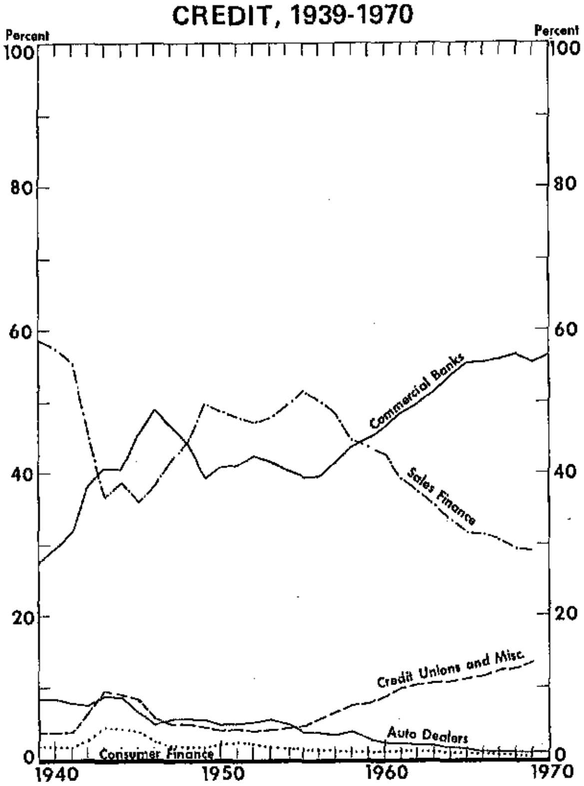
The need to use credit because of the stage in the family life cycle is clearly demonstrated in Part B of Exhibit 2-9. Young married couples with children were the most frequent users of consumer instalment credit; about seven-tenths had instalment debts. When the family head was age 45 or older, instalment credit was used by three-fifths of the families when children were present, by about one-third when the head of household was working and no children were at home, and by about one-sixth when the head of household was retired and no children were at home.

The frequency of instalment credit use in relation to the age of the family head is, of course, intimately related to the level of income and stage in the life cycle characteristic of that age. Those in the younger age groups shown in Part C of Exhibit 2-9 used instalment credit most frequently. A significant decline in frequency of use did not occur until after age 55.

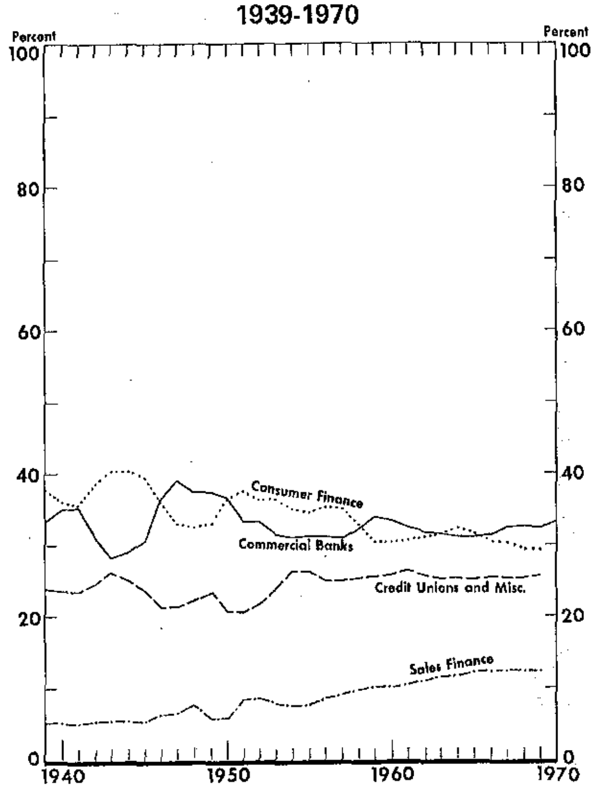
The profile that emerges is that the consumer most likely to employ instalment credit to acquire goods and services is young, married, with children at home and with a family income between $7,500 and $15,000. The stage in the life cycle of the family appears to be most influential in determining frequency of use, while the level of income probably has a greater influence on the quantity of debt and the quality of the goods and services acquired.

EXHIBIT 2 - 5

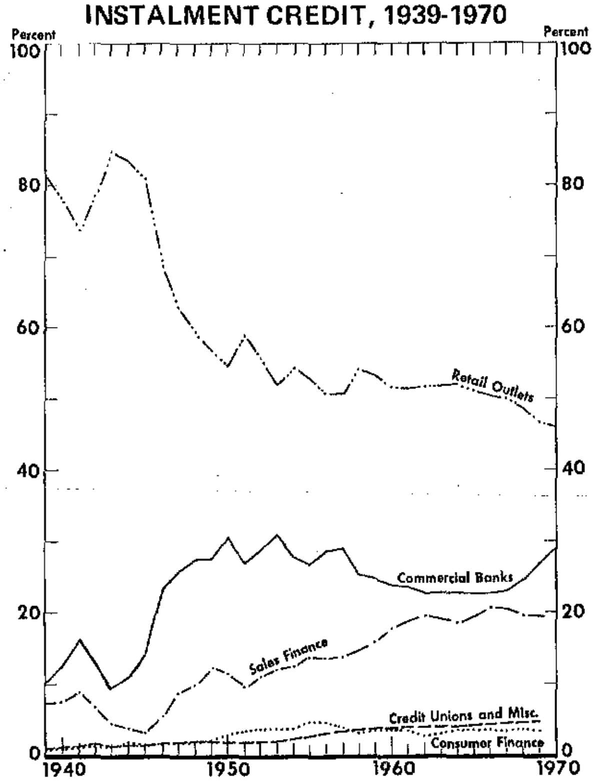
HOLDERS OF AUTOMOBILE INSTALMENT CREDIT, 1939-1970



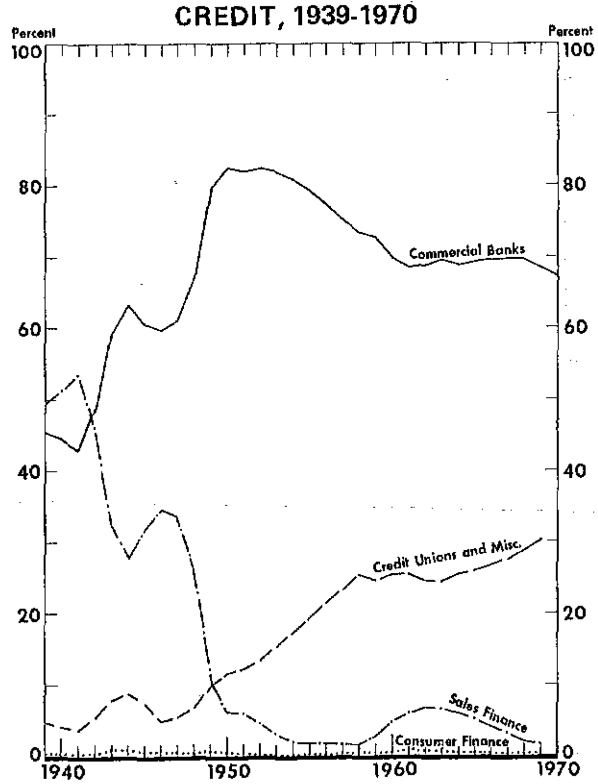
HOLDERS OF PERSONAL LOANS, 1939-1970



HOLDERS OF OTHER CONSUMER GOODS INSTALMENT CREDIT, 1939-1970



HOLDERS OF REPAIR AND MODERNIZATION CREDIT, 1939-1970



SOURCE: National Commission on Consumer Finance based on FRB data.

EXHIBIT 2-6

CONSUMER INSTALMENT CREDIT BY MAJOR TYPE AND MAJOR SOURCE, JUNE 30, 1971
(in billions of dollars)

	Total	Automobile Paper	Mobile Home Paper	Home Repair & Modernization Loans[a]	Personal Loans	Boats, Aircraft & Recreational Vehicles Paper	Other Consumer Goods Paper	Revolving Credit
Consumer Instalment Credit	100.5	37.4	6.5	5.0	26.0	2.0	11.8	11.7
Commercial Banks	49.6	22.5	3.9	3.7	9.1	1.3	4.0	5.2
Finance Companies	24.6	8.7	2.3		11.3	.2	2.1	
Credit Unions	14.5	6.2	.3	1.1	5.0	.5	1.3	
Mutual Savings Banks	.8	.1	(b)	.2	.5	(b)	(b)	
Retail Outlets	11.0						4.4	6.6

Note: Data may not add to totals because of rounding.

[a]Excludes credit held by savings and loan associations.

[b]Less than .05.

Source: National Commission on Consumer Finance, Survey of Consumer Credit Volume, Second Calendar Quarter, 1971, and Consumer Credit Outstanding, June 30, 1971.

EXHIBIT 2-7

AVERAGE CUSTOMER ANNUAL PERCENTAGE RATES OF CHARGE ON SELECTED TRANSACTIONS WITH COMMERCIAL BANKS, MUTUAL SAVINGS BANKS AND RETAIL OUTLETS

JUNE 30, 1971

	Typical Customer APR[a] Charged by		
Type of Credit	Commercial Banks	Mutual Savings Banks	Retail Outlets
New Automobile, $3,000, 36 months			
Direct loan	10.08	9.92	n.a.
Purchased paper	12.10	n.a.	n.a.
Mobile Home, $7,000, 72 months			
Direct loan	10.87	11.70	n.a.
Purchased paper	12.12	n.a.	n.a.
Home Repair and Modernization, $2,500, 60 months, non-FHA			
Direct loan	11.57	11.39	n.a.
Purchased paper	12.09	n.a.	n.a.
Other Consumer Goods			
Direct, $100, 12 months	n.r.	n.r.	17.90
Direct, $300, 24 months	n.r.	n.r.	17.89
Purchased Paper, $500, 24 months	15.89	n.a.	n.a.
Personal Loans, Unsecured			
$1,000, 12 months	12.76	12.52	n.a.
$1,000, 24 months	12.87	12.34	n.a.
Credit Card Plans			
$100 merchandise balance	18.00	n.a.	(b)
$100 cash advance balance	17.30	n.a.	n.a.

Notes: n.a. indicates "not applicable."
n.r. indicates data "not reported."

[a]Median of state mean APR's.
[b]Because of system of graduated rates used in some states, average rates were not computed.

Source: National Commission on Consumer Finance, Survey of Consumer Credit Volume, Second Calendar Quarter, 1971, and Consumer Credit Outstanding, June 30, 1971.

EXHIBIT 2-8

AVERAGE CUSTOMER ANNUAL PERCENTAGE RATE OF CHARGE, AMOUNT FINANCED, AND MATURITY FOR SELECTED TYPES OF CREDIT EXTENDED BY FINANCE COMPANIES BETWEEN JUNE 17 AND JUNE 30, 1971

Type of Credit	Customer APR[a] *(%)*	Amount Financed[a] per Contract *(dollars)*	Maturity[a] *(months)*
New Automobile, purchased paper	12.33	3,048	34.47
Other Consumer Goods, purchased paper	20.37	334	17.87
Personal Loans	25.80	958	26.02

[a]Median of state means.

Source: National Commission on Consumer Finance, Survey of Consumer Credit Volume, Second Calendar Quarter, 1971, and Consumer Credit Outstanding, June 30, 1971.

EXHIBIT 2-9

DEMOGRAPHIC CHARACTERISTICS OF FAMILIES WITH CONSUMER INSTALMENT DEBT, EARLY 1971

	Percentage having instalment debt
A. By annual family income	
Less than $3,000	29
$3,000 - 4,999	39
$5,000 - 7,499	51
$7,500 - 9,999	53
$10,000 - 14,999	60
$15,000 or more	46
All families	48
B. By life cycle stage of family head	
Under age 45:	
Unmarried, no children	41
Married, no children	66
Married, youngest child under 6	68
Married, youngest child age 6 or older	70
Age 45 or older:	
Married, has children	60
Married, no children, head in labor force	34
Married, no children, head retired	16
Unmarried, no children, head in labor force	34
Unmarried, no children, head retired	12
Any age, unmarried, with children	63
All families	48
C. By age of family head	
Under age 25	66
25-34	67
35-44	62
45-54	51
55-64	36
65-74	18
75 or older	8
All families	48

Source: *1971 Survey of Consumer Finances,* (Ann Arbor, Michigan: Survey Research Center, University of Michigan, August 1971), Statistical Report 2, Table 2-3.

IS CREDIT USED EXCESSIVELY?

The desire of credit grantors to provide credit and the eagerness of consumers to acquire goods and services financed with credit may, indeed, lead consumers to use credit to excess. But, forces operate to counteract over-reliance on credit. First, most suppliers hesitate to grant credit if they doubt that the consumer can repay. Every extension of credit represents a bet in a sense, and as the consumer becomes progressively burdened with debt, the odds against repayment increase, and the likelihood that the creditor will accept the applicant decreases. Availability of collection remedies also influences the chances of collection (see Chapter 3). Second, most consumers hesitate to assume obligations they cannot repay. Surveys show that consumers are generally aware of the monthly payments required on instalment purchases—an indication of their concern about fitting instalment credit obligations into their budgets. To measure the effectiveness of these two constraints on the excessive use of credit the Commission examined the adequacy of consumers' incomes to meet repayment obligations, the balance sheet position of consumers, and, finally, evidence concerning problems consumers have faced in repaying their debts. On the fringe of the market, there may be marginal suppliers of credit who encourage marginal borrowers who cannot obtain credit elsewhere to become overextended. Part of this fringe exists in the legal market where credit is primarily a means of selling low quality goods at high prices, and part is in the illegal market where credit is provided at rates far above legal ceilings. Because many of the data examined are aggregates, many of the conclusions about overindebtedness are drawn from analysis of the consumer sector as a whole.

Repayments and disposable personal income

To measure the burden of consumer credit it is useful to compare annual repayments on consumer instalment credit to disposable personal income—that is, the personal income available to consumers after personal tax and nontax payments to governments. The comparison is analogous to a measure of coverage of fixed charges used to assess the ability of a business firm to carry its debts. After a rise in the 1950's, the ratio of annual instalment repayments to disposable personal income stabilized in the range of 14.5 to 15.0 percent (Exhibit 2-10). During the 5-year period, 1967-1971, payments never exceeded 15.0 percent of disposable personal income and never fell below 14.7 percent.

EXHIBIT 2-10
Instalment Credit Repayments as a Percentage of Disposable Personal Income (Seasonally Adjusted)

Percent	*Percent*
1929 - 6.4	1965 - 14.7
1939 - 8.6	1966 - 14.9
1949 - 8.2	1967 - 14.9
1955 - 12.2	1968 15.0
1960 - 13.1	1969 - 15.0
1964 - 14.5	1970 - 14.8
	1971 - 14.7

Source: Board of Governors of the Federal Reserve System

Because the ratio of repayments to disposable personal income is purely an aggregate measure, it is useful to examine data showing the dispersion of the ratios of annual payments on instalment debt to disposable income (Exhibit 2-11). No statistically significant change is evident in the proportion of families having payments on instalment debt amounting to 10 percent or more of disposable income in the previous year. Some reduction in the relation of payments to income in 1970 was probably induced by the recession that year. The slight change in the 5-to-9 percent category is probably not significant except for 1970 and 1971. In short, the dispersion of payments in relation to disposable personal income remained steady for the 7-year period and suggests no material change in the willingness and ability of consumers to assume obligations to repay debt from anticipated disposable personal income.

While the ratio of repayments on consumer instalment credit to disposable personal income may appear to be a useful target for "prudent" family money management, the wide dispersion in the ratio among families contradicts any such simplistic approach. Income is not the only determinant of a family's level of debt. The number and ages of actual and potential dependents, the stability of the wage earner's employment, the health of the family, and its liquid assets holdings are only a few of the many factors that bear on a family's ability to carry consumer debt. In addition, Exhibit 2-11 shows only payments on consumer instalment debt and omits other required disbursements, such as rental or mortgage payments, and payments on noninstalment consumer credit, such as 30-day charge accounts.

EXHIBIT 2-11

RATIO OF ANNUAL INSTALMENT DEBT PAYMENT TO PREVIOUS YEAR'S DISPOSABLE INCOME

Ratio	Proportion of families						
	1965	*1966*	*1967*	*1968*	*1969*	*1970*	*1971*
None	51	51	52	52	49	51	52
1 to 4 percent	8	7	7	7	6	12	13
5 to 9 percent	11	13	12	14	15	15	13
10 to 19 percent	17	18	19	18	19	14	13
20 to 39 percent	9	8	7	7	8	5	5
40 percent or more[a]	1	1	2	2	3	1	2
Not ascertained	3	2	1	-	-	2	2
	100	100	100	100	100	100	100

[a] Includes families with zero or negative disposable income.

Source: George Katona, W. Dunkelberg, G. Hendricks, and J. Schmiedeskamp, *1969 Survey of Consumer Finances* (Ann Arbor, Mich.: Survey Research Center, University of Michigan, 1970), p. 21; George Katona, Lewis Mandell, and J. Schmiedeskamp, *1970 Survey of Consumer Finances* (Ann Arbor, Mich.: Survey Research Center, University of Michigan, 1971), p. 25; *1971 Survey of Consumer Finances,* (Ann Arbor, Mich.: Survey Research Center, University of Michigan, August 1971), Statistical Report 2, Table 2-4.

Even if these and other significant economic and demographic factors could somehow be reflected in a model for the "proper" levels of debt for a family, there would be no allowance for differences in life style among families. Each family has a unique value system under which it allocates resources among goods and services, both for present and for future consumption. Thus a financial yardstick representing an average family will not serve a specific family. At best, it can only warn of extreme levels of debt.

Balance sheet position

In determining the ability of a business firm to assume debt, financial analysts commonly use two measures. The first relates repayment obligations to income, a test of the sort just applied to consumers' instalment debt. The second measure, derived from the firm's balance sheet, may take the form of the ratio of current assets to current liabilities (the "current ratio") or of the ratio of debt to net worth. To some extent these balance sheet tests can be applied to consumers' debts.

The data in Exhibit 2-12 demonstrate the very liquid position of consumers at the end of 1971. Although in the aggregate consumers had more than enough in their savings deposits to repay outstanding home mortgages and consumer credit obligations, this was not true of all individual consumers. Nonetheless, the overall picture is one of strength, because most of the financial assets could be liquidated into immediate cash, whereas many of the debts extend over several years (particularly home mortgages). Not shown in the table are the fixed assets of consumers—their homes and the various consumer durables whose purchase was facilitated by the liabilities listed in the table. Also not shown in the national accounts are nontangible assets such as education, often financed by credit. If these data were available, the ratio of debt to net worth of American consumers would be negligible.

Problems in repaying debt

Even though aggregate data suggest that credit grantors and consumers have been cautious in arranging obligations, some individual consumers have problems repaying their debts. At the extreme these problems result in bankruptcy. In the early 1960's the rate of nonbusiness bankruptcies per 100,000 of population rose from 73 to 85 (Exhibit 2-13). Since 1965, the rate seems to have stabilized with the exception of 1967 when nonbusiness bankruptcies reached 98 per 100,000 population.

EXHIBIT 2-12

BALANCE SHEET POSITION OF CONSUMERS[a] AT YEAR-END 1971
(In billions of dollars)

Financial Assets		
Demand deposits and currency	$134.9	
Savings accounts	496.0	
Corporate shares	878.6	
Other credit market instruments	224.9	
Life insurance reserves	137.0	
Pension fund reserves	268.1	
Miscellaneous assets	30.9	
Total financial assets	$2,170.4	
Total Liabilities		
Credit market instruments:		
Home mortgages	$296.1	
Other mortgages	21.9	
Consumer instalment credit	109.5	
Other consumer credit	27.7	
Bank loans (other)	25.8	
Other loans	22.2	$503.2
Security credit, trade credit and other		22.6
Total liabilities		$525.8

[a]Households, personal trusts, and nonprofit organizations.

Source: *Federal Reserve Bulletin*, 58 (June 1972), p. A73.15.

EXHIBIT 2-13

Nonbusiness Bankruptcies per 100,000 of Population (Fiscal year ending in June)

1961 - 73	1966 - 91
1962 - 72	1967 - 98
1963 - 75	1968 - 92
1964 - 82	1969 - 85
1965 - 85	1970 - 88
	1971 - 88

Source: Based on data contained in Annual Report of the Director of the Administrative Office of the United States Courts, 1971 (Washington, D.C.: U.S. Government Printing Office, 1972) pp. 227-238, 381-392.

The number of nonbusiness bankruptcies relative to population varied greatly among states. For example, for the fiscal year ending June 30, 1971, the number of nonbusiness bankruptcies (including Chapter XIII of the Bankruptcy Act) per 100,000 of population in a sample of states ranged as follows:[23]

Nevada	264	Texas	14
Alabama	260	New Jersey	13
Kansas	195	Maryland	12
Tennessee	189	Pennsylvania	12
Oregon	179	South Carolina	8

An earlier study, based on the *1960 Survey of Consumer Finances*, attempted to identify the characteristics of consumers who have excessive instalment debt and sought an economic explanation for excessive indebtedness.[24] Ryan and Maynes classified excessive indebtedness into two categories: families in "some trouble" and "deep trouble." After eliminating for technical reasons 194 of the 1417 families in the sample

with some instalment debt, the researchers found 39 percent of the remaining families with debt in "some trouble," and, within this group, 11 percent in "deep trouble." The classification system was based on these assumptions:

1. The greater the debt payments-to-income ratio, the greater the probability that a family's debt position will lead to "trouble."
2. If a family's liquid assets minus a "transactions balance" of $200 exceeds outstanding instalment debt, instalment debt owing will pose no trouble.
3. The higher a family's income, other factors being constant, the greater the debt payments-to-income ratio it can sustain without encountering trouble.

Ryan and Maynes noted the following with respect to personal characteristics of the overindebted.

"The greatest proportions of debtors in trouble were found among the unmarried (especially the separated, divorced, and widowed), the poor, and those under 25 or 65 years and older .... About 40 percent of single-person households and Negro households were, by our definitions, in deep trouble.... Households headed by women were more likely to be headed for debt troubles.... Education (given its correlate, income) was inversely related to debt trouble. Also.. .families with children are those least likely to be in trouble due to instalment debt. And conversely, households without children—at both extremes of the life cycle—are more likely to be in trouble.... the longer a household head has been married, the less likely that it is in debt trouble."[25]

The economic characteristics of the overindebted were related to the lack of full-time participation in the

EXHIBIT 2-14

WHETHER FAMILIES MADE MONTHLY PAYMENTS AS SCHEDULED IN 1968

(Percentage distribution of families with debt or mortgage payments)

	Paid as scheduled	Paid faster or larger amounts	Both—"got behind" and "faster or larger"	Got behind	NA DK[a]	Total
All families with payments						
1968	71	13	3	7	6	100
1967	71	12	3	7	7	100
Annual disposable family income						
Less than $3,000	62	7	1	17	13	100
$3,000-$4,999	72	4	4	11	9	100
$5,000-$7,499	74	8	3	10	5	100
$7,500-$9,999	68	17	4	8	3	100
$10,000-$14,999	72	16	4	4	4	100
$15,000 or more	77	15	1	1	6	100
Ratio of annual instalment debt payments to disposable income						
Less than 5 percent	74	13	1	5	7	100
5-9 percent	73	14	3	6	4	100
10-19 percent	69	13	4	9	5	100
20-39 percent	67	11	6	10	6	100
40 percent or more	74	9	2	9	6	100

[a]Not ascertained, don't know.

Source: George Katona, Lewis Mandell and J. Schmiedeskamp, *1970 Survey of Consumer Finances* (Ann Arbor, Michigan: Survey Research Center, University of Michigan, 1971), p. 33.

labor force, residence outside of major metropolitan areas, as well as residence in the South. Homeowner-debtors were less likely to be in "trouble" than other debtors.

Additional evidence of possible excessive acquisitions of debts by consumers is available in the *1969 Survey of Consumer Finances.* About 10.5 percent of the families with debt payments reported rescheduling debt payments during 1968. This amounted to 5.4 percent of all families.[26]

Exhibit 2-14 shows that families with low incomes were more likely to get behind in their payments than families with high incomes, hardly an unexpected result. Among those with incomes above $7,500 about one-sixth paid faster than required by contract. Interestingly enough, one-fifth of those with very small debts (less than $100) reported that they got behind, whereas only one-tenth paid faster than required. As shown in the lower part of Exhibit 2-14 the proportions of "slow-payers" and "fast-payers" were about the same for families whose instalment payments exceeded 20 percent of their annual disposable family income. This result suggests that relatively high ratios of debt repayments to income are not a sure portent of trouble, as often alleged, but may also indicate a greater ability to incur and carry debt.

Conclusion

Consumer credit has been an economic fact of life since Colonial days. The rapid growth of consumer credit in the United States has in large part been a natural accompaniment to the growth of other forms of debt, both public and private. At the end of 1971, consumer credit still amounted to somewhat less than 7 percent of net public and private debt. Consumers' use of credit has been encouraged by their rising discretionary income, the urbanization of the population, and the influx of younger consumers into the market. A particularly important influence has been the trend to homeownership and its accompanying shift to owned durable goods in substitution for purchased services. The growth of asset ownership has also been stimulated by the increased number of women in the work force.

The result of these social and economic developments has been the creation of $137.2 billion of consumer credit as of the end of 1971. This credit has been classified by the Federal Reserve Board into noninstalment and instalment credit, the latter being by far the larger portion. Each of these two classes is further segmented according to the purpose for which the credit was granted. To the extent possible, each of these two classes is further segmented according to the purpose for which the credit was granted. The amounts of credit outstanding are also classified according to the financial institution or other business that holds the receivables. Except for personal loans and other consumer goods credit, commercial banks are the largest holders of each sub-class of instalment credit and of single-payment cash loans. Credit unions have shown the most rapid growth in their holdings of consumer instalment credit over the past two decades. Within just the past 3 years, outstandings generated by bank credit cards have shown the greatest rate of growth.

In spite of the increase in outstanding consumer credit, analysis of aggregate data does not indicate a dangerous situation of overindebtedness. Although a small portion of consumers resort to bankruptcy each year, most consumers appear to be able and willing to meet their obligations; in fact, the families who pay in advance of scheduled maturities seem to outnumber those who fall behind in their payments. The remaining chapters will explore in much greater detail the adequacy of the consumer credit markets to serve the American consumer, including the underprivileged in our society.

Chapter 3

CREDITORS' REMEDIES AND CONTRACT PROVISIONS

INTRODUCTION

One of the most controversial areas in consumer credit is that of creditors' remedies. Any discussion of modification or abolition of some creditors' remedies and clauses included in most consumer credit contracts is accompanied almost axiomatically by impassioned argument in defense of the status quo or in behalf of change. Such discussions are usually permeated with a fervid intolerance for contrary opinion—an attitude common to consumer groups and creditors alike. Past attempts at modification, restriction, or abolition of certain creditors' remedies and certain clauses in consumer credit contracts have been subjected to criticism and dissatisfaction and to charges of "too little too late," "overly protective of the consumer," and "paternalistic."

Against this theoretical background the Commission examined the subject of creditors' remedies and contract provisions as part of its inquiry into "The adequacy of existing supervisory and regulatory mechanisms to protect the public from unfair practices."

Traditionally consumer credit legislation has focused on specific problem areas or areas of abuse with the idea of correction, modification, or outright change. Little attention has been paid to the effect and impact such legislation might have on the availability of consumer credit and on the consumer credit market. Most consumer credit legislation has been passed without recognition of its effect on the rate of charge and availability of credit to consumers. So the Commission compiled and analyzed as much relevant data as possible on the use of various creditors' remedies and contract provisions so that its recommendations would fully reflect the probable impact of any recommendations for change.

In June 1970 at a hearing on debt collection practices the Commission heard many witnesses, some of them attorneys directly involved in the collection process, relate their experiences with abusive debt collection activities. A number urged curtailment or prohibition of several debt collection practices, creditors' remedies, and consumer credit contract clauses because of harsh effects resulting from their abuse.

Because restricting or abolishing certain collection devices and remedies would probably have direct effects on credit grantors as well as users, the Commission felt obligated to consider industry views, too.

Believing that further public hearings to gather industry opinion might fail to afford all industry segments—large and small, single state and multistate operators—an equal opportunity, the Commission concluded that the best way to ascertain the full impact of curtailing or restricting remedies was to survey parts of industry.

Collection Practices and Creditors' Remedies Survey (hereinafter, *Survey*) data together with results from another state-by-state survey of major types of consumer credit extended and outstanding and their average rates of charge gave the Commission a factual basis for estimating probable effects if certain collection practices, creditors' remedies, and contract provisions were restricted or abolished. Resultant recommendations recognize the need to achieve and maintain a fair balance of rights and duties between creditor and debtor in consumer credit transactions.

Survey results indicated that most creditors thought debtors failed to meet their contractual obligations because they became unemployed, ill, or overextended after incurring the debt, not because they were "deadbeats" who never intended to repay. Still, creditors overwhelmingly preferred that the full panoply of remedies be available as collection tools.

Few states place restrictions on all the methods by which creditors can collect past due obligations. It has been traditional for limitations on methods of collection to be left for the parties to work out in the contract. But the time has come to recognize that in consumer credit transactions the creditor's ability to use a full range of collection devices is not a matter for creditor-debtor negotiation but a set of contractual conditions imposed by the creditor on "a take-it-or-leave-it basis."[1] The disparity in bargaining power between creditor and debtor in consumer transactions is a fact of the marketplace which has been recently recognized by several Federal and state court decisions[2] as well as by a British Committee which studied consumer credit.[3] The standard form contract, with provisions drawn almost

496-072 O - 73 - 4

entirely from the creditor's standpoint, is further evidence of inequality of bargaining power.[4]

A step necessary to help equalize the positions of participants in the consumer credit market is to restrict or abolish those creditors' remedies and collection practices which, in view of the major reasons for default, are likely to cause undue hardship. Under existing rate structures and legal restraints on new entry into certain consumer credit markets (Chapters 6 and 7), any abolition or restriction of creditors' remedies or collection practices may result in reduced credit availability or higher rates, or both, to segments of the consuming public. Thorough analysis of Commission *Survey* findings support this hypothesis. Nonetheless on public policy grounds the Commission believes that abolition or restriction of some creditors' remedies and collection practices is in the best interest of the public, generally. While recognizing the need for more balanced legislation, the Commission realizes that creditors, too, have rights and are entitled to legal protections. Its recommendations for legislation concerning remedies and contracts are intended to afford debtor-consumers protections they cannot obtain through bargaining and still to give creditors the tools they need to collect just debts.

Recommendations regarding remedies are inextricably interwoven with Commission recommendations on rates and availability (Chapters 6 and 7). It is imperative that the relationship be realistically assessed—the higher the rate the fewer the remedies needed and *vice versa.* States may decide to narrow or broaden Commission recommendations on remedies and contract provisions. But they should recognize that modifications are likely to affect the cost and availability of consumer credit.

Contract Provisions and Creditors' Remedies

Contract Provisions

Acceleration Clauses—Default—Cure of Default

Acceleration clauses in consumer credit contracts—for both cash and sale credit—are provisions "by which the time for payment of the debt is hastened or advanced because of the breach of some condition of the contract by the debtor."[5] Under the Uniform Commercial Code (hereinafter, Code) the creditor may accelerate payment (hold the entire debt, including future instalments, due and payable) upon default[6] by the debtor or some contract provision or "when the creditor deems himself insecure." Such clauses are used in unsecured transactions as well as in those where the creditor takes a security interest in goods in the debtor's possession.

At common law, acceleration clauses were grouped according to the instances which gave rise to the creditor's right to accelerate. In its most typical form, the clause permitted the creditor to accelerate when the debtor defaulted, and the contract would enumerate those instances which constituted default[7]—usually nonpayment of principal or interest.[8] The other form of acceleration clause allowed the creditor to accelerate at will when he deemed himself insecure.[9] Under common law the creditor had the burden of justifying the acceleration and proving his "good faith."[10] Courts would not enforce acceleration clauses if the creditor had accelerated in "bad faith" or if the clause provided that upon acceleration not only the principal but the full amount of the interest for the full term of the contract also came due.[11] Once the creditor had established his right to accelerate, he was usually authorized to collect the entire principal plus legal interest. But upon default in conditional sales contracts where the creditor also had a security interest in goods in the possession of the debtor, the creditor had to elect his remedy to determine the method of recovery.[12] He could *either* exercise his right of possession and take back the goods (on the theory that title in the goods was reserved to him by the conditional sales contract) *or* he could forego repossession and sue the debtor for the amount owed. Under the first option the creditor would be relying solely on the value of the collateral, and if it were not sufficient to discharge the debt in full, he would lose the amount of the deficiency. Under the second option, the creditor would be relying on all of the nonexempt assets of the debtor; if the debtor were insolvent, the creditor would collect nothing.

The Code specifically allows acceleration triggered by the creditor's insecurity as well as by default. Upon *default* a secured party has the power to repossess collateral without judicial intervention, provided the parties have enumerated the conditions of *default* in the contract.

Under section 1-208 of the Code, a creditor may accelerate "at will" or "when he deems himself insecure," if he is in "good faith" and believes the prospect of his receiving payment has been impaired. The test of "good faith" is totally subjective and allows the creditor's judgment alone to determine whether payment is likely to be forthcoming or the security is endangered. A further complication under the Code is that if a creditor accelerates under a "deem-insecure" clause, the burden of proving the creditor did not act in "good faith"—that he actually did not believe his security was about to be impaired—falls on the debtor. If the creditor retakes the collateral, allegedly following a debtor's default, the burden of proving that the default did not occur also falls on the debtor.

The validity of acceleration after default is sound and essential to effective remedial action by the creditor

since it would be unduly onerous, inequitable, and expensive to require the creditor to sue for each instalment of the contract as it became due after the initial default. However, it is equally onerous and inequitable to place on the debtor the burden of proving a creditor's "bad faith" in invoking acceleration solely on the basis of insecurity.

Acceleration of the maturity of all or any part of the amount owing in a consumer credit transaction should not be permitted unless a default as specified in the contract or agreement has occurred.

A creditor should not be able to accelerate the maturity of a consumer credit obligation, commence any action, or demand or take possession of any collateral, unless the debtor is in default, and then only after he has given 14 days prior written notice to the debtor of the alleged default, the amount of the delinquency (including late charges), the debtor's right to cure the default, and any performance in addition to payment required to cure the default.

Under such circumstances, for 14 days after notice has been mailed, a debtor should have the right to cure a default arising under a consumer credit obligation by:

1. *tendering the amount of all unpaid instalments due at the time of tender, without acceleration, plus any unpaid delinquency charges; and by*
2. *tendering any performance necessary to cure a default other than nonpayment of accounts due.*

However, a debtor should be able to cure no more than three defaults during the term of the contract. After curing default the debtor should be restored to all his rights under the consumer credit obligation as though no default had occurred.

Acceleration should be permitted only upon the actual default of the debtor. A consumer-debtor should not be subject to the acceleration of the maturity of his obligation solely because the creditor believes the prospect of payment of the debt has been impaired. Default should not be defined by statute, but should be left to the determination of the parties according to the terms of the contract. But default should not result from technical violations of minor contract terms or from violations of terms unrelated to ensuring payment of the debt or maintaining the reasonable value of the security; it should result only from the breach of major contract provisions, such as failure to make timely payments of interest or principal, unauthorized disposition of collateral, or failure to keep the collateral insured.[13]

The Commission believes a debtor should be given written notice of an alleged default so that he has opportunity to challenge or at least question the creditor's determination of default. If, indeed, a default has occurred, recommendation of a 14-day cure period starting with the mailing of the notice of alleged default is merely the adoption of current industry practice. The *Survey* disclosed that, before declaring an account delinquent (with all the legal consequences attendant to such determination), banks allowed average grace periods of 12.2 days and finance companies 16.5 days. The average grace periods were derived from all types of credit extended by those institutions–personal loans, other consumer goods, bank credit cards, and automobile loans.

The right to initiate suit and repossess collateral, if any, is important in the event of default. Perhaps nowhere is this right more important than in the automobile credit market where the value of the collateral is so important. The Commission is reluctant to interfere unnecessarily with the workings of that or any other credit market. But since grace periods allowed in the auto credit market were included in the computation of the overall average grace period, the Commission believes it can justifiably and safely recommend a 14-day cure of default period for all credit markets without unduly jeopardizing the creditor's collateral and opportunity to recover or unduly diminishing the availability of credit to the consumer.

Attorneys' Fees

In many states, creditors are able to include in consumer credit notes and contracts a clause providing for payment by the debtor of attorneys' fees if the debtor defaults on the contract. This is usually expressed as a percentage of the amount in default irrespective of the actual amount of attorneys' fees incurred by the creditor. Other states, however, prohibit such contractual provisions. The prohibition is most common in small loan laws. Section 2.413 of the Uniform Consumer Credit Code (UCCC) provides alternatives,–one authorizing, one prohibiting attorneys' fees.

Consumer credit contracts or agreements should be able to provide for payment of reasonable attorneys' fees by the debtor in the event of default if such fees result from referral to an attorney who is not a salaried employee of the creditor; in no event should such fees exceed 15 percent of the outstanding balance. However, the agreement should further stipulate that in the event suit is initiated by the creditor and the court finds in favor of the consumer, the creditor should be liable for payment of the debtor's attorney's fees as determined by the court, measured by the amount of time reasonably expended by the consumer's attorney and not by the amount of the recovery.

The *Survey* showed that many creditors believed attorneys' fees were useful to collection activities and that they often relied on that provision. But, in view of the *Survey* finding that major reasons for default stem from situations beyond the debtor's control, the Commission finds it in the best interest of all to limit

recovery to 15 percent of the outstanding balance owed at default.

The Commission recommends allowing attorneys' fees provisions in consumer credit notes and contracts because such fees should be borne directly, but to a reasonable extent, by the debtor. Costs of collecting from defaulting debtors should not be borne indirectly by all the creditor's customers in higher rates of charge to cover higher overhead.

Confessions of Judgment–Cognovit Notes

Confessions of judgment refers to a "judgment taken by warrant of attorney included in the instrument creating the obligation and consenting to judgment before the commencement of suit."[14] In effect, the debtor allows an attorney chosen by the creditor to appear in a court of proper jurisdiction and enter judgment at any time against the debtor without notifying or serving process on the obligor-debtor and usually prior to any default. When confession is allowed at any time after execution of the contract, the creditor is immediately permitted to acquire a judgment lien on any property of the debtor, real or personal.

At common law, judgment by confession was permitted in a pending suit and still seems to be permitted and regulated. In such cases, unlike the confession note, the suit has already been commenced, and the defendant has already received service of process before execution of the confession.

Statutory prohibition or restriction of the cognovit note probably stemmed from a desire by most states to preserve for the debtor his day in court. Entry of judgment without the debtor's knowledge gives the creditor a powerful weapon and enables him to coerce payment by the debtor who might otherwise have reasonable grounds for withholding payment.

Only seven states permit confession of judgment by warrant of attorney prior to commencement of suit. Of these, only in Illinois, Ohio, and Pennsylvania has the use of confessions been widespread. In 1961 a prominent legal scholar declared that a nonnotice type cognovit judgment violated the 14th Amendment.[15] Professor Dan Hopson argued that the consent to have judgment entered was not consent but part of a contract of adhesion.[16] He said the signer of a cognovit note did not, in fact, consent to such a provision since he had no effective choice.

In 1970 in the case of *Swarb v. Lennox*, a Federal district court banned the Pennsylvania practice of taking judgments by confession and thus obtaining a security interest in the debtor's property before the debtor had an opportunity to be heard.[17] The court, although recognizing that the right to a hearing might be waived, presumed that no intelligent waiver could be made regarding consumer credit transactions when the consumer earned less than $10,000.

The Supreme Court recently affirmed in full the decision in *Swarb*, including its exclusive applicability to those earning less than $10,000.[18] While suggesting that the Pennsylvania cognovit judgment procedure was not unconstitutional on its face, the Court in another decision intimated that such clauses, if part of "contracts of adhesion" or resulting from "bargaining power disparity," might be held unconstitutional.[19] The validity of cognovit notes in consumer credit transactions remains uncertain and resolution of the question appears to depend solely on the adhesiveness of consumer credit transactions.

No consumer credit note or contract should be permitted to contain a provision whereby the debtor authorizes any person by warrant of attorney or otherwise, to confess judgment on a claim arising out of the consumer credit transaction without adequate prior notice to the debtor and without an opportunity for the debtor to enter a defense.

Since most states have either prohibited or severely restricted authorizations to confess judgment, the *Survey* showed little need for or use of confessions of judgment as a collection device. Further, the Commission's cross-state econometric model disclosed that prohibition or restriction of confessions of judgment had no significant effect on the rate of charge for consumer credit or on its availability.

The Commission believes that consumer credit transaction contracts are contracts of adhesion resulting from disparity in bargaining power between debtor and creditor. The adhesive nature of a consumer credit contract is a byproduct of standard forms. Yet nonstandard contracts would probably be economically infeasible to both consumer and creditor. Since standard forms appear to be the only viable means to conduct consumer credit transactions in a system geared to economies of mass production and merchandizing the forms should represent the interests of both creditor and debtor. To accomplish this, the Commission recommends that the Bureau of Consumer Credit (Chapter 4) be empowered to develop and recommend standards for consumer credit contracts. In setting minimum requirements for such contracts, the public interest should be the paramount concern. Such a practice prevails in the insurance industry where insurance commissioners establish uniform policy provisions.

Cross-Collateral

Cross-collateralization is peculiar to credit sales. It occurs when a creditor takes a security interest not only

in the item of the credit sale but also in other goods or property of the purchaser. For example, if a consumer buys a television set and the creditor retains a security interest in the set and also takes a security interest in other appliances of the consumer, the creditor has cross-collateral.

Cross-collateralization may also occur in "add-on" sales. In this type of sale, a creditor "secures" a new sale by adding the purchase to an existing secured instalment sales agreement and not relinquishing security interest in previously purchased goods as each item is paid for. Such cross-collateralization has been discouraged by section 128(d)[20] of TIL which materially complicates making disclosures in such transactions. But to be absolutely certain of preventing this, the instalment agreement should stipulate that all payments must be applied to items acquired earliest and that the creditor must not retain security interest in property for which he has received payments totaling the sale price including finance charges.

In a consumer credit sale, the creditor should not be allowed to take a security interest in goods or property of the debtor other than the goods or property which are the subject of the sale. In the case of "add-on" sales, where the agreement provides for the amount financed and finance charges resulting from additional sales to be added to an existing outstanding balance, the creditor should be able to retain his security interest in goods previously sold to the debtor until he has received payment equal to the sales price of the goods (including finance charges). For items purchased on different dates, the first purchased should be deemed the first paid for and for items purchased on the same date, the lowest priced items should be deemed the first paid for.

The *Survey* disclosed no significant need for or use of the cross-collateralization just described.

The Commission believes a seller-creditor should be permitted to take a security interest only in goods which form the basis of the credit transaction. If, as part of the sale of new goods, the seller consolidates or refinances a debt or debts in which a prior security interest existed the seller should be able to retain a security interest in such prior goods only if the payments received apply to extinguish debts first incurred and security interests first given. Cross-collateralization agreements in which the seller applies payments on a pro-rata basis to all secured items and retains an interest in all goods until the entire debt is paid is an unconscionable practice.

Household Goods

A creditor should not be allowed to take other than a purchase money security interest in household goods.

A creditor should be able to take a security interest in goods which form the basis of the transaction, but security interests in household goods should not be allowed in any loan or consolidation transaction if the goods were not acquired by the use of that credit. In the event of default, such security interest in household goods and the accompanying right to repossess or threat to repossess such goods have far too disruptive an impact on the family life of the debtor to be in the public interest.

Security Interest—Repossession—Deficiency Judgment

In extending consumer credit, the creditor is chiefly concerned that legal remedies provide inexpensive and effective means for investment recovery if the consumer fails to fulfill agreement terms. Perhaps no contract provision gives the creditor more effective protection than security interest and its companion remedy, the right to repossess upon "default." Under the Code, a security interest is defined as "an interest in personal property . . . which secures payment or performance of an obligation." If the debtor defaults,[21] the Code provides that "unless otherwise agreed, a secured party has . . . the right to take possession of the collateral . . . . without judicial process if this can be done without breach of the peace. . . ." In addition to authorizing such "self-help" repossession following debtor default, the Code provides that goods may be taken by "action" such as replevin if "self-help" cannot be accomplished without a breach of the peace.

Giving a creditor the right to take a security interest in goods sold under a credit sale or acquired from proceeds of a loan is certainly not a new practice. The law has historically provided many devices to enable the creditor to diminish risk of loss when financing the sale of both consumer and commercial goods. To protect creditors who provide funds or goods and services and rely solely on the security of personal property, devices such as pledges, chattel mortgages, and conditional sales contracts[22] have "sprung up in a wild profusion."[23] These short-term security devices have enabled lenders to provide working capital for small- and medium-size businesses and to assist in distribution of durable goods to consumers.

The Code provision authorizing the secured party to take possession of collateral following a default without the aid of judicial process, like the security interest, is not a novel collection tool.[24] Apparently use of nonjudicial repossession by a conditional seller was recognized under English common law. Rationale for its use—fear that a debtor will abscond with, destroy, or lose the property before relief can be obtained from the courts—has remained constant. William Blackstone, the noted commentator on English common law, gave the

following justification for proceeding without judicial process:

"The reason . . . is obvious, since it may frequently happen that the owner may have this only opportunity of doing himself justice: his goods may be afterwards conveyed away or destroyed . . . if he had no speedier remedy than the ordinary process of law."[25]

As early as 1869, a court in the United States permitted a conditional seller peaceably to retake a sewing machine without judicial process via the "self-help" route. The court said it would "permit a party to resort to every possible means for the recaption of his property short of a breach of the peace."[26] Courts recognizing nonjudicial repossession as a valid collection mechanism brought about statutory sanction first in 1919 when the National Conference of Commissioners on Uniform State Laws promulgated the Uniform Conditional Sales Act (U.C.S.A.). Section 1 of the Act specifically authorized peaceable nonjudicial repossession upon the debtor's default.

Self-help repossession has come under severe criticism in recent years as being a particularly abusive collection practice in the area of consumer credit.[27] Professor Grant Gilmore, one of the drafters of Article 9 of the Code, observed:

"In the financing of business debtors repossession causes little trouble or dispute. In the underworld of consumer finance, however, repossession is a knock-down, drag-out battle waged on both sides with cunning and guile and a complete disregard for the rules of fair play."[28]

The part of the security interest–repossession process which evokes greatest emotion and criticism is the deficiency judgment. The Code permits the creditor to dispose of the collateral by "public" or "private" sale so long as the sale is, in fact, "commercially reasonable." After sale of collateral the proceeds, before being applied to reduce the consumer's debt, may be used to defray "the reasonable expenses for retaking, holding, preparing for sale, selling and the like and, to the extent provided for in the agreement and not prohibited by law, the reasonable attorneys' fees and legal expenses incurred by the secured party." The remainder is credited to the debt. If the residual applied to the debt is not sufficient to pay it in full (usually it is not), the debtor still owes the secured party the unpaid balance even though he has lost possession and ownership of the goods. For example, if a debt of $2,000 secured by an automobile is defaulted and the car repossessed and sold for $1,800 at public sale, the creditor may apply the proceeds first to expenses incurred in the repossession and sale (say $300) and the balance ($1,500) to the debt. The debtor would still owe the creditor $500 despite loss of the car.

What might be "commercially reasonable" for a commercial creditor and a commercial debtor might not be "reasonable" for a consumer debtor. The latitude the Code allows the secured party in conducting foreclosure sales seems excessive in consumer transactions. The Code shields the secured party with the seal of commercial reasonableness if he sells the collateral "in the usual manner in any recognized market" or at the price "current . . . at the time" in any recognized market, or finally, "if he has otherwise sold in conformity with . . . . practices among dealers in the type of property sold."

Guidelines of the Code clearly sanction wholesale auction sales (the usual manner of disposing of used consumer durables such as autos) since a foreclosure sale is not considered lacking in commercial reasonableness merely "because a better price could have been obtained at a sale at a different time or in a different method from that selected by the secured party."

Use of the Code approved wholesale auction sale virtually guarantees that if the consumer debtor defaults he will be subject to a deficiency. The collateral purchased in the retail market for a retail price is sold after repossession in the wholesale market for a wholesale price. Since most defaults and repossessions usually occur shortly after purchase of the collateral (before much of the debt has been repaid but after the goods have changed from "new" to "used"), the difference in prices between the wholesale and retail markets is particularly wide.

It seems illogical to contend, however, that creditors gear their operations to repossess and then get the "benefit" of the deficiency judgment. A Commission study indicates that except for a few "sharp" dealers this is not the case.[29]

Despite Code sanctions, the very nature of the creditor-dominated consumer contract has caused several courts and state legislatures[30] recently to look with disfavor on the security interest, self-help repossession-replevin, deficiency judgment package. Scrutiny of all remedies which could unilaterally be invoked by a private party to cause state power to deprive a person of his property began after the Supreme Count decision in *Sniadach v. Family Finance Corporation.*[31] The Court held that the Wisconsin statute authorizing prejudgment garnishment of a resident debtor's wages without any opportunity for prior hearing on the merits of the creditor's claim was a deprivation of the debtor's property without due process of law and a violation of the 14th Amendment.

In June 1972 the Supreme Court in *Fuentes et al v. Shevin* held that the Florida and Pennsylvania replevin statutes were unconstitutional because they provided for issuance of prejudgment writs of replevin "ordering state agents to seize a person's possessions simply upon the *ex*

parte application of any person who claims a right to them and posts a bond.[32] The Court pointed out that neither statute provided for notice to be given the possessor of the property or afforded the possessor opportunity to challenge the seizure or any kind of prior hearing. It also noted that prejudgment replevin statutes were descendants of common law actions which permitted prejudgment seizure by state power. But the Court emphasized that the common law required "some kind of notice and opportunity to be heard to the party then in possession of the property and a state official made at least a summary determination of the relative rights of the disputing parties before stepping into the dispute and taking goods from one of them."[33]

Although the Court's opinion in *Fuentes* seems directed only at instances in prejudgment seizure cases when the *state acts* to deprive a person of property without prior notice and opportunity to be heard, many constitutional scholars feel that after *Fuentes* the demise of self-help repossession is inevitable. There is some basis for this view. In *McCormack v. First National Bank of Miami*[34] the Federal district court tested the constitutionality of self-help repossession provisions of the Code against the due process criteria of *Sniadach* and found the provisions constitutionally sound. It upheld the constitutionality of self-help repossession when such right was provided for by contract and refused to distinguish self-help from a contractual authorization of replevin. The irony of this result is that the court felt compelled to follow the decision of the Federal district court in *Fuentes v. Faircloth,*[35] the very decision which the Supreme Court overruled and in which prejudgment replevin, even though contractually authorized, was held unconstitutional. In other words, if the Supreme Court's decision in *Fuentes* had been decided prior to the *McCormack* case, the court in *McCormack* would have found self-help repossession unconstitutional.[36]

More recently, in the case of *Adams v. Egley*, the Federal District Court for the Southern District of California found self-help repossession, as allowed by the Code, to violate the due process clause of the 14th Amendment.

In spite of arguments that self-help repossession was stipulated in the security agreements and therefore a matter of private contract, the court found that Code Sections 9-503 and 9-504 authorizing self-help and deficiencies set forth a state policy

> "and the security agreements upon which the instant actions rest, whose terms are authorized by the statute and which incorporate its provisions, are merely an embodiment of that policy."[37]

The court emphasized that it was "therefore apparent that the repossessions were made under color of state law" and that the Code sections authorizing such activities were "constitutionally defective and void."[38]

Having decided that self-help repossession was "state action" sufficient to entitle parties who would be deprived of property to due process protections of notice and opportunity to be heard, the court considered whether a consumer in a credit transaction could waive his constitutional rights. It determined that "while a signed contract may represent an effective waiver where the contracting parties are of equal bargaining power, it clearly is not so in all cases, particularly those involving so-called 'adhesion contracts', in which the terms are specified by the seller or lender."[39] Citing the case of *Laprease v. Raymours Furniture Co.* in which the prejudgment replevin statute of New York was found unconstitutional, the court in *Adams v. Egley* intimated that it would not be able to find an effective waiver of constitutional rights where standard-form contracts were involved.[40] The attitude toward "adhesion" in *Adams v. Egley* may well cause the greatest problems for creditors.

The Supreme Court in *Fuentes* also dealt with the matter of adhesion contracts, pointing out that in the *Fuentes* contracts "there was no bargaining over contractual terms between the parties, who, in any event, were far from equal in bargaining power."[41] The Court emphasized that the "purported waiver provision (in the security agreement) was a printed part of a form sales contract and a necessary condition of the sale."[42] The intimation seems clear: it is unlikely that a waiver of the right to notice and opportunity to be heard can be "voluntarily, intelligently and knowingly"[43] made in a consumer credit contract.

A seller-creditor should have the right to repossess goods in which a security interest exists upon default of contract obligations by the purchaser-debtor. At the time the creditor sends notice of the cure period (14 days), and prior to actual repossession (whether by replevin with the aid of state officers or by self-help), he may simultaneously send notice of the underlying claim against the debtor, and the debtor should be afforded an opportunity to be heard in court on the merits of such claim. Such time period for an opportunity to be heard may run concurrently with the cure period.

Where default occurs on a secured credit sale in which the original sales price was $1,765 or less, or on a loan in which the original amount financed was $1,765 or less and the creditor took a security interest in goods purchased with the proceeds of such loan or in other collateral to secure the loan, the creditor should be required to elect remedies; either to repossess collateral in full satisfaction of the debt without the right to seek a deficiency judgment or to sue for a personal judgment on the obligation without recourse to the collateral, but not both.

The *Survey* disclosed that creditors thought the single most important remedy or contract provision in a secured consumer credit transaction was the right to

take a security interest in the goods (use the goods as collateral for the transaction) and the concomitant right to repossess if the debtor defaulted.

At the time of the *Survey* virtually all states permitted creditors to take a security interest in goods and to repossess for debtor default, so the Commission could not measure what impact restriction or abolition of these companion collection devices might have on availability of consumer credit and rates charged for it. The Commission is unable to predict with any certainty probable effects of limitations, but the degree of creditor support for these collection devices indicates that any restriction, much less abolition, of them would probably have significant impact on rates charged for consumer credit and its availability. There is little doubt that the rate of charge would be substantially increased and availability severely curtailed if the right to a security interest and to repossess were restricted.

With full understanding of its probable impact, the Commission, nevertheless, recommends that prior to repossession—whether with or without judicial process—the debtor must be given notice of the claim against him and the opportunity to be heard on the merits of the underlying claim.

Leaving legal niceties for the courts, this recommendation is based on the concept that an individual has the right to continued "use and possession of property (free) from arbitrary encroachment."[44] If the evil to be eliminated is that of depriving a person of his property rights without procedural due process of law, the right to notice and an opportunity to be heard must apply across the board, irrespective of the type of repossession—"self-help," replevin, or whatever.

The type of notice to be given the debtor and the nature of the hearing are of critical importance. The Commission believes that the type of summons recently adopted under the Wisconsin Consumer Act would provide the debtor with adequate notice of the claim pending against him and notice of his opportunity to be heard. The notice reads:

> "The Plaintiff named above has commenced an action to recover possession of the following property:
>
> [Description of Collateral]
>
> This claim arises under a consumer credit transaction under which you are alleged to be in default, as described in the attached complaint.
>
> If you are not in default or have an objection to the Plaintiff's taking the property listed above, you may arrange for a hearing on these issues by appearing in the County Court of____________County, in the Courthouse in the City of____________ Judge____________or any other Judge of said Court to whom the action may be assigned, on________day of________ A.D. 19__ at________ o'clock in the________ noon. If you do not appear at that time, judgment will be rendered against you for delivery of such property to the plaintiff."

The nature of the hearing, however, presents a more difficult problem. Offering the debtor an opportunity to be heard does not guarantee the debtor will avail himself of the opportunity. The *Survey* showed that in approximately 65 percent of all court cases the consumer failed to appear and judgment was entered by default for the creditor-plaintiff. There is no reason to believe that a greater percentage of debtors would appear at hearings prior to repossessions.

A "probable cause" type hearing, where the secured party and debtor have an opportunity to appear to present their case and to file affidavits, would probably satisfy the opportunity-to-be-heard requirement of the 14th Amendment. Although hearings of this type would probably be unduly burdensome to the existing court system, the Commission insists that an opportunity for hearing should be granted.

Although the functioning and structure of the existing court system is beyond Commission purview, this panel notes that reorganization of the courts is desperately needed. In many jurisdictions, the courts are now unable to accommodate existing caseloads. They will be completely incapable of handling efficiently the large number of cases generated by proliferating consumer protection laws, to say nothing of the hearings herein recommended. The Commission strongly endorses a reorganization of the court system and supports any actions necessary to accomplish that end.

The recommendation to prohibit deficiency judgments for default on a secured credit sale in which the original price was $1,765 or less or on a loan in which the original amount financed was $1,765 or less is made despite the probability of increased rates of charge on such transactions and reduced availability. But the Commission believes implementation of that recommendation would afford consumers protection in areas particularly susceptible of abuse by exempting most household goods purchases from deficiency judgments and putting an end to deficiency judgment abuses found in some used car markets.

The Commission position on this recommendation and the $1,765 figure designated are derived from the Commission hearings on collection practices and findings of a Commission Study on Repossession of Cars in the District of Columbia. Both highlighted deficiency judgment mechanism problems peculiar to the used car market. To isolate this market, the Commission determined the point in 1972 at which new and used car markets were no longer in competition. Aware that the average automobile loan approaches 100 percent of dealer cost, the Commission ascertained dealer cost of the lowest priced passenger cars made by each U.S.

automobile manufacturer and computed an average of $1,765.[45] Automobile credit higher than that figure would more likely be extended to buy a new rather than a used car. So it was at the figure of $1,765 or less that the Commission determined the 1972 new car market was not in substantial competition with the used car market. The figure should be recomputed annually using average prices of the least expensive American-made passenger cars.

Since most major household goods such as stoves, refrigerators, washers, dryers, and furniture do not separately cost more than $1,765, the prohibition against deficiencies provides the consumer some protection in major household purchases. The Commission believes that if the debtor defaults after purchasing major household goods, the creditor should have the option of repossessing or suing on the debt, but not both. To allow otherwise would cause too great a personal hardship.

Wage Assignment

Wage assignment is a transfer by a debtor to a creditor of the debtor's right to collect all or a given part of his wages, earned and unearned. Traditionally, the wage assignment was irrevocable and was taken by the creditor as either payment or security for a debt. Its function, like self-help repossession, was to provide the creditor with a speedy method of collection without a hearing on the merits of the underlying claim.

Many states have restricted the right of the creditor to obtain wage assignments. The restrictions cover a full range. In some states, wage assignments are completely prohibited; in others they are limited to a given percentage of the debtor's earnings. Some states require that the assignment be accepted by the debtor's employer.

The validity of wage assignments is in doubt because of recent decisions in *Sniadach* and *Overmeyer*. While wage assignments are distinguishable from prejudgment garnishment in that the former are contractual, they are essentially contracts of adhesion. The policy enunciated in *Sniadach* regarding protection of wages and the statements in *Overmeyer* holding that if the contract were adhesive "other results might ensue" suggest that the future of wage assignments as collection devices is clouded.

In consumer credit transactions involving an amount financed exceeding $300, a creditor should not be permitted to take from the debtor any assignment, order for payment, or deduction of any salary, wages, commissions, or other compensation for services or any part thereof earned or to be earned. In consumer credit transactions involving an amount financed of $300 or less, where the creditor does not take a security interest in any property of the debtor, the creditor should be permitted to take a wage assignment but in an amount not to exceed the lesser of 25 percent of the debtor's disposable earnings for any workweek or the amount by which his disposable earnings for the workweek exceeds 40 times the Federal minimum hourly wage prescribed by section 6(a)(1) of the Fair Labor Standards Act of 1938 in effect at the time.

Wage assignments generally represent a potentially disruptive force to the wage earner, the family, and their pattern of living. The irrevocable wage assignment permits the creditor to reach the debtor's past and, in many cases, future earnings without a determination by the courts on the merits of the underlying claim. The Commission makes this recommendation despite findings from the cross-state econometric model that restrictions or prohibitions on the use of wage assignments would reduce the number and amount of credit union personal loans.

The Commission also recognizes that small unsecured loans which often serve a useful purpose would not be made available unless the creditor had an effective and inexpensive method of collecting in the event of default.

For many low income wage earners, the only pledgable, tangible asset is a paycheck. To deny the right to obtain credit based on that asset is to fail to recognize the individual's earning capacity and to withhold opportunity afforded more affluent members of society.

The *Survey* indicated that sales and consumer finance companies, as well as some small banks, relied to a significant extent on wage assignments to collect on defaulted obligations. The cross-state econometric analysis of the finance company sector of the personal loan market indicated that where wage assignments were prohibited or substantially restricted the number but not the dollar amount of loans made per family was reduced significantly. This suggests that restriction or prohibition of wage assignments has greatest impact on loans of $300 or less because significant reductions in the number of loans of this size would not necessarily have much impact on the total dollar amounts extended.

The unwillingness of lenders to make loans of this size without an effective and inexpensive method of collecting in the event of default is understandable. The small size loan is the most costly to make in relation to the amount lent,[46] and unless creditors can collect without incurring additional expenses, such as attorneys' fees and court costs, they probably would not make such loans. The wage assignment device provides an inexpensive method of collection.

In view of its general opposition to wage assignments, the Commission believes they should be allowed only when the creditor extends credit on an unsecured basis,

relying solely on the debtor's earning capacity. But, it also recommends that where a wage assignment is allowed and becomes operative due to default, if it should cause the debtor hardship because of an unexpected emergency, such as illness of the debtor or the family, the debtor should have the right to ask an appropriate court to stay the operation of the assignment until such time as it can be reinstated without causing undue hardship.

Waiver of Defense Clauses are discussed in the Holder in Due Course section.

Creditors' Remedies

Body Attachment

To the enlightened society of the 20th century, the thought of a debtor being imprisoned for failing to pay his debts seems preposterous and barbaric. Nevertheless, in June 1970 the Commission was told of "debtor's prisons" still operating in the State of Maine.[47]

Several articles trace the development of "Execution Against the Body of the Judgment Debtor" from early Roman law to the mid-20th century.[48]

Most states have substantially restricted imprisonment for debt, either by constitutional prohibition or statutory restraints. In some states the prohibition is absolute, and others permit it only in specific instances, such as when a debtor is found to have committed willful tort or to have absconded with intent to defraud creditors. Nevertheless, in several states debtors are still imprisoned for failure to pay their debts but the basis for incarceration is contempt of court for failing to obey the court's order to pay the debt.[49]

No creditor should be permitted to cause or permit a warrant to issue against the person of the debtor with respect to a claim arising from a consumer credit transaction. In addition, no court should be able to hold a debtor in contempt for failure to pay a debt arising from a consumer credit transaction until the debtor has had an actual hearing to determine his ability to pay the debt.

As a matter of public policy, if imprisonment for debt still exists in any form, the Commission recommends its abolition. However, if after final judgment, and after notice and actual hearing and any other necessary procedural safeguards, a court has reasonably determined that the debtor has refused to pay a court-ordered sum when he has capacity to do so, the court should be able to initiate contempt proceedings.

Garnishment

Garnishment is a "statutory proceeding whereby [a] person's property, money or credit in possession or under control of, or owing by, another are applied to the payment of the former's debt to [a] third person . . . ."[50] As it applies to wages and salaries, the process of garnishment requires an employer to withhold part of an employee's compensation upon order of the court and pay it directly to, or for the account of, the employee's creditor.

In spite of the description of garnishment as a "statutory proceeding," garnishment proceedings "are truly blue-blooded legal institutions that can claim a family tree reaching back into the Middle Ages."[51] Garnishment is a descendant of the procedure of "foreign attachment," whereby a plaintiff who brought suit against a nonresident defendant could attach the defendant's goods found in the hands of a third person or stop payment of debts owed by the third party to the nonresident defendant. If the nonresident failed to appear at the trial and had a judgment entered against him, the plaintiff could seek satisfaction out of the nonresident's seized assets.[52]

Attachment procedures made an early appearance in the Colonies,[53] and in 1683[54] the province of Maryland passed the oldest known garnishment act in the United States. It regulated attachment proceedings against absentee defendants when third persons had in their possession "goods, chattels, or credits" belonging to the absentee defendants. The third parties were labeled "garnishees" and given specific liability regarding the garnished items.

Late in the 17th century and throughout the 18th century attachment statutes were made applicable to domestic defendants. The creditor could "reach and apply" the assets—"chattels, goods or credits"—of domestic debtors about to flee the jurisdiction. When attachment was so used, it served a security function—the function garnishment of wages has in consumer credit transactions today.

The 19th century saw considerable legislative and judicial expansion of the nature of property which could be reached in satisfaction of debt.[55] "Wage garnishment followed as a logical extension of this trend. Since wage garnishment developed after the abolition of debtor's prisons, it did not seem unreasonable and was in the spirit of the nineteenth century principles of freedom of contract and survival of the fittest. . . . [P]olicy factors involved in allowing creditors to force a wage cut on blue collar employees were never seriously considered in the formative years of the remedy, a period when the primitive industrial state did not require massive consumer credit. Subsequently, state legislatures, acting alternatively under the pressures of both organized labor, and the business community, attempted to regulate the remedy by exemptions, inclusions and exclusions producing a quagmire of difficult and confusing rules."[56]

During the 20th century state legislatures were active in enacting restrictions on wage garnishment laws developed during previous years. Exemptions and exceptions ranged from complete prohibition to limitations based on various percentages of salaries in excess of a given amount, to limitations based on the character of the wages and status of the person whose wages were being garnished.

In today's consumer credit market, garnishment of some percentage of a debtor's wages seems justifiable and necessary. In most consumer credit transactions, the only asset of the consumer on which the creditor relies for his security is the consumer's earning power. It is not surprising that the creditor should expect to be able, and, some might argue, be entitled, to reach some portion of that asset in the event of the debtor's default. Both Congress and the Supreme Court appear to agree that the creditor is entitled to garnish a debtor's wages. Congress has prescribed the maximum amount of the garnishment and the Court has proscribed the method of garnishment.

The restriction on garnishment in the Consumer Credit Protection Act (CCPA) became effective on July 1, 1970. It provides that

> "[T]he maximum part of the aggregate disposable earnings of an individual for any workweek which is subjected to garnishment may not exceed
> (1) 25 per centum of his disposable earnings for that week, or
> (2) the amount by which his disposable earnings for that week exceed thirty times the Federal minimum hourly wage . . . whichever is less."

Restated, the CCPA's Title III exempts from garnishment whichever is greater—75 percent or $48 (30 X 1.60, the current minimum wage)—of the debtor's disposable income per workweek.

Example 1.

If a debtor has a disposable income of $100 per week, $75 is exempt from garnishment.

Example 2.

If a debtor has a disposable income of $55 per week $48 is exempt from garnishment (75 percent would be only $41.25).

In addition to limiting the amount of wages subject to garnishment, Title III provides that "no employer may discharge any employee by reason of the fact that his earnings have been subjected to garnishment for any one indebtedness." Title III exemptions from garnishment are minimum exemptions because the Act specifically provides that it does not annul, alter, or affect state laws which prohibit garnishment or provide more limited garnishment than does the CCPA or prohibit discharge of an employee for garnishment.

As to garnishment methods, the Supreme Court has held that a garnishment cannot be obtained against a debtor residing in the state where the garnishment is sought simply on petition of one party—the creditor—before judgment. The Court in *Sniadach v. Family Finance Corporation* held that the temporary withholding of a resident debtor's wages under a garnishment order without opportunity for the debtor to be heard or to present any available defense to the creditor's claim was violative of procedural due process granted under the 14th Amendment. Justice Douglas, writing for the majority, held that such prejudgment garnishment affords "enormous" leverage to creditors and "may as a practical matter drive a wage-earning family to the wall."[57] Prejudgment garnishment of out-of-state debtors is apparently still permitted.

Prejudgment garnishment, even of nonresident debtors, should be abolished. After entry of judgment against the debtor on a claim arising out of a consumer credit transaction, the maximum disposable earnings of a debtor subject to garnishment should not exceed the lesser of:

1. *25 percent of his disposable earnings for the workweek, or*
2. *The amount by which his disposable earnings for the workweek exceeds 40 times the Federal minimum hourly wage prescribed by section 6(a)(1) of the Fair Labor Standards Act of 1938, in effect at the time the earnings are payable. (In the event of earnings payable for a period greater than a week, an appropriate multiple of the Federal minimum hourly wage would be applicable.)*

A debtor should be afforded an opportunity to be heard and introduce evidence that the amount of salary authorized to be garnished would cause undue hardship to him and/or his family. In the event undue hardship is proved to the satisfaction of the court, the amount of the garnishment should be reduced or the garnishment removed.

No employer should be permitted to discharge or suspend an employee solely because of any number of garnishments or attempted garnishments by the employee's creditors.

The Commission believes that Title III of CCPA was a giant step toward more effective and equitable consumer protection. It put limits on garnishment where none—or almost none—existed in many states, and it geared those limits to the minimum wage, not to an inflexible dollar amount. It provided the debtor-employee with some measure of job security in the event of garnishment for

one debt. But the Commission feels that the CCPA protections should be further improved.

A wage earner working a full 40-hour week at the minimum hourly rate earns, by standards recognized by Congress, the minimum amount necessary to support a family at a bare subsistence level. To exempt from garnishment an amount based on a 30-hour workweek seems unreasonable. It does not afford those employees earning the minimum wage with adequate means to provide basic necessities. For this reason the Commission recommends that the exempted portion of an employee's salary be increased to 40 times the Federal minimum wage.

The Commission recommends that an employee should not be subject to discharge for garnishments or attempted garnishments by any number of creditors because the loss of employment causes further hardship on the debtor and his family and virtually guarantees inability to satisfy any obligations. Furthermore, the Commission feels that creditors should not be able to garnish indiscriminately the nonexempt portion of the debtor's disposable income. In given circumstances, such as illness in the family and previous unemployment, garnishment of the nonexempted portion of the debtor's salary may make it impossible for him to provide for himself and his family. Under such extraordinary circumstances, the Commission believes the debtor should have an opportunity to present the facts to a court and let the court, if it deems proper, adjust the amount of the garnishment.

Because garnishment is one of the most common and effective means by which a creditor can enforce a judgment against a defaulting debtor, it was deemed an essential collection device by both secured and unsecured creditors in the Commission's *Survey*. It was considered *the* most essential remedy by creditors extending unsecured credit, and in secured transactions it was ranked second only to the right to take a security interest. The cross-state econometric model indicated that in states where garnishment was either prohibited or restricted beyond limitations imposed by the CCPA, the availability of credit was substantially curtailed, and charges for credit were apparently increased. These findings lead the Commission to recommend that garnishment be allowed in all states subject to the restrictions discussed.

Holder in Due Course Doctrine—Waiver of Defense—Closely-Connected Loans

Of all creditors' remedies and collection devices used in consumer credit notes and contracts, perhaps none has received as much notoriety, commentary, and controversy as the holder in due course (HIDC) doctrine.[58]

In 1758, in the case of *Miller v. Race*, the King's Bench of England held that a Bank of England promissory bearer note was "treated as money; as cash" by businessmen dealing "in the ordinary course and transaction of business."[59] The court decided that when such a note was stolen and thereafter sold to a person who paid fair value and had no notice of the theft (a bona fide purchaser), that bona fide purchaser would prevail over all persons claiming the note, even the original owner. The rationale for this decision was based on the fear that the growth and soundness of commerce would have been impeded or destroyed if a contrary decision were reached.[60] This fear was probably well-founded because promissory notes of the Bank of England were not "legal tender,"[61] but were nevertheless "passed from hand to hand, serving many of the purposes of paper money, which did not exist in England at the time."[62] To allow persons other than bona fide purchasers to claim ownership to the note would indeed have had an adverse affect on commerce.

With the development of paper money, the emphasis on affording a good faith purchaser of notes and contracts freedom from claims to the instrument gradually shifted to permit the good faith purchaser to cut off defenses which the obligor may have against paying the note.

Today, under the Code an individual can qualify as HIDC if he takes an instrument for "value," "in good faith" and "without notice that it [the instrument] is overdue or has been dishonored or of any defense against or claim to it on the part of any person." The status of HIDC provides many advantages against the individual obligated on the instrument, and these advantages are brought into sharp focus where the instrument is used in a consumer credit transaction.

In a typical consumer credit purchase of durable goods, the purchaser signs an instalment note to the seller agreeing to repay the unpaid portion of the purchase price plus finance charges in accordance with a stipulated repayment schedule. The seller, in turn, "negotiates" the note to a financing institution (usually a sales finance company or bank). In most of these transactions the financing institution has the status of HIDC and can enforce the purchaser's obligation on the note irrespective of any defenses which the buyer may have against the seller regarding the underlying sale. For example, if a purchaser signs a note as payment or partial payment for a refrigerator, the financing institution holding the note as HIDC is entitled to receive payment even though the refrigerator was defective, was never delivered, or, if delivered was not as represented at the time of the sale.

Another legal device, the waiver of defense clause, provides financing institutions immunity from defenses

to payment which the buyer may be able to assert against the seller. It operates in essentially the same way as the HIDC doctrine. A waiver of defense clause is part of an instalment sales contract (as distinguished from a note) and, in effect, provides to the assignee of the contract the benefits of negotiability and HIDC status through a contractual provision.

The following is an example of a typical waiver of defense clause:

> "If the seller should assign the contract in good faith to a third party, the buyer shall be precluded as against such third party from attacking the validity of the contract on grounds of fraud, duress, mistake, want of consideration or . . . . "

The Code specifically permits such clauses, unless there is a "statute or decision which establishes a different rule for buyers or lessees of consumer goods. . ."

Recently, both courts and legislatures have begun to reassess and scrutinize the validity and the impact of the HIDC doctrine and waiver of defense clauses in consumer credit transactions. A number of courts have denied HIDC status to lenders in "too close connection" with sellers of consumer goods.[63] A number of state legislatures have prohibited use of negotiable instruments, and, therefore HIDC status, in retail instalment sales of "service."[64] Waiver of defense clauses in consumer sales contracts have also been held void as against public policy by a number of courts[65] and prohibited by several legislatures.[66]

Besides absolutely prohibiting the use of negotiable instruments and waiver of defense clauses in consumer transactions, a number of state legislatures have limited the prohibition to certain spheres of the consumer credit market or have only prohibited the use of waivers and not HIDC.[67] Others have provided a delay period before the cut-off of defenses becomes effective.[68] The financial institution is required to give notice to the consumer of the assignment and sale of the contract or note and identify the seller of the goods. Thereafter the consumer has a limited period of time to notify the financial institution of any complaints or objections regarding the merchandise. If the financial institution does not receive such notice within the time period, any defenses which the buyer may have had against the seller can be cut off by the financial institution.

As far as the Commission can determine, the delaying type statute affords the consumer no real protection. The financing institution sends the notice of transfer to the consumer as a routine matter on transfer, and it is unlikely that the consumer would know of any defects or defenses other than nondelivery at the time of receipt of the notice of transfer. Most of these statutes provide an unrealistically short period in which to assert a defense. Finally, it is possible that if the seller of the goods sold the paper immediately, notice of assignment might be received by the consumer before the delivery date.

In addition to activity at the state level, a proposed trade rule offered at one time by the FTC but later withdrawn would have made the use of either HIDC status or a waiver of defense clause in a consumer transaction an unfair and deceptive practice.[69]

Growing discontent with cut-off devices in consumer transactions, now apparent in legislatures, courts, and administrative agencies, has led many dealers and financing institutions to devise a new and effective method for the lender to cut off any defenses the buyer might have against the seller. The seller merely suggests that the buyer borrow money for the purchase by direct loan from a cash lender and directs the buyer to a financing institution willing to make the loan. Theoretically, at least, the loan is an independent transaction with no relation to the purchase of the goods. As a result, the obligation to repay the debt would not be subject to defenses arising out of the purchase transaction even in states limiting the HIDC doctrine and use of waiver of defense clauses. The Commission believes routine referral by a seller to a lender or group of lenders should not be permitted to subvert the policy behind a rule restricting or prohibiting use of negotiable promissory notes or waiver of defense clauses. However, drafting legislation barring routine referrals but not inhibiting direct lending for consumer purchases by institutions totally independent of sellers is a difficult task.[70]

Whatever the methods, it is quite apparent that cut-off devices against defenses which a purchaser of consumer goods may have against the seller of such goods are in great disfavor in many courts and with many legislators. Many noted legal scholars also agree that cut-off devices are not necessary in consumer transactions.[71]

Notes executed in connection with consumer credit transactions should not be "negotiable instruments;" that is, any holder of such a note should be subject to all the claims and defenses of the maker (the consumer-debtor). However, the holder's liability should not exceed the original amount financed. Each such note should be required to have the legend "Consumer Note-Not Negotiable" clearly and conspicuously printed on its face.

Holders of contracts and other evidences of debt which are executed in connection with consumer credit transactions other than notes should similarly be subject to all claims and defenses of the consumer-debtor arising out of the transaction notwithstanding any agreement to the contrary. However, the holder's liability should not exceed the original amount financed.

A creditor in a consumer loan transaction should be subject to all of the claims and defenses of the borrower arising from the purchase of goods or services purchased with the proceeds of the loan, if the borrower was referred or otherwise directed to the lender by the vendor of those goods or services and the lender extended the credit pursuant to a continuing business relationship with the vendor. In such cases, the lender's liability should not exceed the lesser of the amount financed or the sales price of the goods or services purchased with the proceeds of the loan.

Responses to the Commission's *Survey* disclosed that very few creditors engaged in purchasing consumer credit notes and contracts thought that the HIDC doctrine or waiver of defense clauses were among the legal tools most essential to collection activities; but they did indicate reliance on these collection devices to a significant extent in legal actions to collect defaulted obligations.

The cross-state econometric model indicates that in those states which have prohibited both HIDC and waiver of defense clauses there has been an observable reduction in the availability of other consumer goods credit in two areas: consumer finance companies purchased less other consumer goods paper, and the total amount of other consumer goods credit made available in the retail market declined. Traditionally, finance companies have served the greatest proportion of retailers dealing with high risk credit customers, although banks, too, serve that market. The reductions in availability of other consumer goods credit from finance companies, in all likelihood, would have the greatest impact on consumers who are marginal credit risks and on those businesses which serve or may potentially serve such consumers.

The cross-state econometric model results also suggest that if finance companies cannot take other consumer goods paper free from claims and defenses to quality of the goods and services, the reduction in credit availability in the other consumer goods retail market would probably be greater than that of the finance company component of the market. Finance companies could reduce their activity in the market by quality credit rationing—rejecting higher risk customers to reduce costs and offset additional potential credit losses. This, in turn, would probably force out of the market many retailers serving marginal risk consumers unable to obtain credit from general market retailers. Because many of these marginal retailers are undercapitalized and tend to be basically inefficient[72] they depend on finance company purchase of paper to restock their inventories. These same limitations would prevent other potential small retailers from entering the market in the absence of finance company other consumer goods credit.

At the time of the *Survey*, all states allowed either HIDC or waiver of defense clauses or some other equally effective cut-off device in the indirect automobile market. For this reason comparable data were not available to test the effect of prohibiting HIDC and waiver of defense clauses on availability of indirect automobile credit. However, no evidence is available to show that the effect of such prohibitions in the auto indirect market would have any less impact than in the other consumer goods market.

In recommending abolition of HIDC and waiver of defense clauses in consumer credit transactions, the Commission recognizes that it is placing the burden of policing consumer transactions on the financial institutions which purchase consumer paper. The Commission believes those financial institutions are in a much better position to control credit practices of retail suppliers of consumer goods and services than are consumers. They can choose the retailers and suppliers with whom they will do business. If a financial institution is subject to consumers' defenses against payment, such as failure of consideration, nondelivery, etc., it will discontinue purchase of paper from those merchants who cause trouble thereby forcing the many merchants who desire to stay in business but need financial institutions to buy their consumer credit paper to "now react responsibly to consumer complaints in order to keep the avenue of credit open."[73]

Great Britain's Committee on Consumer Credit expressed the rationale for abolishing HIDC and waiver of defense clauses rather simply when it stated:

> "If an obligation to repay is incurred in the first instance to the supplier . . . . and the right to receive payment is then transferred to a third party taking with notice of the fact that the debt stems from a consumer credit transaction, then we consider that the third party ought not to stand in a better position than the supplier himself, whether the obligation to repay arises under the supply contract or under a separate promissory note."[74]

Of all the arguments for abolishing a financial institution's freedom from consumer defenses, Professor Homer Kripke of New York University, who describes himself "as a (former) finance company lawyer", provides perhaps the best rationale:

> "Looking at the matter legislatively, we may ask who, as between the consumer and financer, ought to bear the risk of the merchant's breach of warranty or delivery of shoddy goods? The consumer sues the merchant only once or episodically.

The financer, even though it does not control the merchant or participate in the breach of warranty, ordinarily has a continuing relationship with him and some experience of his performance of warranties. The financer is certainly better equipped with staff to check the merchant's reputation for reliability and fair dealing. It is submitted that the risk of cases of legitimate customer dissatisfaction should be thrown on the financer. The financer is best able to force redress by maintaining an action over against the merchant or by charging withheld amounts in the financer's hands, even where his basic purchase of the obligation from the merchant was without recourse. The financial institution always protects itself by warranties from the merchant as to freedom of the obligation from customer defenses. Moreover, such a rule would cut-off the sources of credit of a merchant with repeated bad warranty relations with his creditors.

"The clinching argument is the contrast between the legal relationships in consumer financing and the legal relationships in the financing of commercial accounts receivable. In that field the financing institutions, many of which are also engaged in the consumer field, have never sought to extend to the commercial field their assertion that they are entitled to freedom from customer defenses. There is one simple reason for this: the commercial buyers would not stand for it, for the purchase contracts in the commercial field are not contracts of adhesion. What then happens to the question of freedom from defenses in the commercial field? The financer as part of its credit determination studies the experience of the seller in respect to customer complaints and returned goods, and if the percentage is too high, refuses to do business with that merchant. The same type of credit thinking would provide the answer in the consumer field."[75]

With abolition of cutoff devices, it is only logical to assume that the financing institutions would probably protect themselves by increasing the dealer reserve (the percentage of each contract price retained by the financial institution as a fund against which to charge bad debts and other credit losses of that particular dealer) or by decreasing the dealer's participation (the dealer's share of the finance charge) in each consumer credit transaction. In either case, the ultimate burden of increased costs to dealers would likely be passed on to the consumer in the form of higher cash prices for the goods or services or in the form of higher finance charges, or both.

The Commission believes spreading the costs of abolishing third party cutoff devices to all consumers in the marketplace would be more than counter-balanced by the protections which the consuming public will receive in the form of better goods and services. Moreover, the repercussions will probably not be as significant as some have suggested.[76] The Commission agrees with Professor Kripke, when he states:

"In a reputable milieu—reputable merchants, reputable products, reputable financers—the freedom from defense rule is statistically unnecessary . . . . Its time has run out."[77]

The Commission's recommendation regarding connected loans is intended to prohibit financing institutions and sellers and suppliers of goods and services from circumventing restrictions on cutoff devices by resorting to direct loan financing arrangements. Making a connected lender subject to the claims and defenses of consumers arising in the underlying transaction will deter interlocking loan arrangements between sellers and financing institutions intended to afford the financing institutions the same cutoff devices available with purchased paper. Lenders will receive no protection where the seller and lender have a continuing business relationship in which the seller directs or otherwise refers the consumer to a particular lender for a purchase money loan. The recommendation is intended to close the umbrella of protection which direct loan financing offers connected lenders.

The Commission has not attempted to define a connected lender. It has, instead, listed those factors and incidents of dealing which it deems relevant to any determination of a continuing relationship between a vendor and a lender sufficient to establish the connection.

For this purpose it should be ascertained whether:

1. The lender supplied forms to the seller, lessor or supplier of services which the consumer used in obtaining the loan.

2. The seller, lessor or supplier prepared or assisted in preparation of documents used to evidence the loan.

3. The lender is related to or affiliated with the seller, lessor, or supplier of services.

a. With regard to individuals, "related to" refers to any familial relationship;

b. With regard to corporations, firms, partnerships, trusts, and other organizations, "affiliated with" refers to (1) direct or indirect control of or by any such organization, (2) interlocking directorates or other form of joint or common management of two or more organizations, or (3) familial relationship with an officer, director, owner, partner, trustee, or similar official of an organization.

4. The lender directly or indirectly pays the seller, lessor, or supplier of services, any commissions, fees, or other consideration measured by or based in any way on the consumer loan.

5. The lender has knowledge—including knowledge from dealing with other customers of the seller, lessor or supplier of services or knowledge from records or notices of complaints by other such customers—that the seller, lessor, or supplier of service failed to perform agreements with customers or fails to remedy valid complaints.

6. The lender has repeatedly and regularly made loans in a 1-year period to finance purchases of goods or services from the seller, lessor, or supplier of services, or persons related to or organizations affiliated with the seller, lessor, or supplier of services, and the lender was recommended to the consumer for the loans in question.

The Commission believes holding connected lenders liable for consumer claims and defenses stemming from underlying transactions is necessary to the goal of preserving consumer defenses by abolishing cutoff devices in purchased paper transactions.[78] The abolition of cutoff devices should also be extended to credit card transactions. Where the lender is the issuer of a credit card which may be used by the consumer in a sale, lease, or service transaction with the seller, lessor, or supplier of services, the lender-issuer should be subject to the customer's claims and defenses, *except* in those transactions where the credit card is merely a substitute for cash (e.g. transactions up to $50).

Any attempt to deal with third party cutoff devices such as HIDC and waiver of defense clauses involves a question of balance. The needs of small businessmen to obtain capital to enter and remain in the market serving marginal risk consumers must be weighed against the protection of all consumers. The balance is sometimes a delicate one. In this case it is not. The Commission firmly believes that consumers have an absolute right to receive fair value in the purchase of goods and services. One way to help achieve this goal is to abolish the HIDC doctrine and waiver of defense clauses. The inevitable reduction in availability of consumer credit in some markets will be more than offset by increased consumer confidence in the market as a whole.

Levy on Personal Property

This discussion is related solely to post-judgment collection mechanisms—the enforcement of judgments. Such enforcement is necessary for the creditor to be able to collect judgments he has obtained.

Today, for the most part, judgments for money or for possession of property are enforced by writs of execution just as they were at common law. If it is a money judgment, the writ of execution authorizes the proper state officer (usually a sheriff or marshall) to seize any property (including the home) of the defendant not exempt by statute from seizure, sell it at an execution sale, and apply any proceeds derived toward satisfaction of the judgment. In many states, recordation of a money judgment also effects a lien on the defendant's real property, besides allowing seizure and sale of personalty.[79] A judgment for possession of property is enforced similarly, except that sale does not usually follow seizure.

Prior to entry of judgment against a debtor arising out of a consumer credit transaction, while a court may create a lien on the personal property of the debtor, that lien should not operate to take, or divest the debtor of possession of the property until final judgment is entered. However, if the court should find that the creditor will probably recover in the action, and that the debtor is acting or is about to act in a manner which will impair the creditor's right to satisfy the judgment out of goods upon which a lien has been established, the court should have authority to issue an order restraining the debtor from so acting. The following property of a consumer debtor should be exempt from levy, execution, sale, and other similar process in satisfaction of a judgment arising from a consumer credit transaction (except to satisfy a purchase money security interest created in connection with the acquisition of such property).

1. *A homestead to the fair market value of $5,000 which should include a house, mobile home, or like dwelling, and the land it occupies if regularly occupied by the debtor and/or his family as a dwelling place or residence and intended as such.*

2. *Clothing and other wearing apparel of the debtor, spouse, and dependents to the extent of $350 each.*

3. *Furniture, furnishings, and fixtures ordinarily and generally used for family purposes in the residence of the debtor to the extent of the fair market value of $2,500.*

4. *Books, pictures, toys for children and other such kinds of personal property to the extent of $500.*

5. *All medical health equipment being used for health purposes by the debtor, spouse, and dependents.*

6. *Tools of trade, including any income-producing property used in the principal occupation of the debtor not to exceed the fair market value of $1,000.*

7. *Any policy of life or endowment insurance which is payable to the spouse or children of the insured, or to a trustee for the benefit of the spouse or children of the insured except the cash value or any accrued dividends thereof.*

8. *Burial plots belonging to the debtor and/or spouse or purchased for the benefit of minor children to the total value of $1,000.*

9. *Other property which the court may deem necessary for the maintenance of a moderate standard of living for the debtor, spouse, and dependents.*

The Commission believes that the current system of having a court establish a lien on personal property of the debtor prior to a judgment is an acceptable procedure providing the debtor is not deprived of the right to retain possession of the property until judgment is entered. It also believes that widely differing state-by-state personal property exemptions which now exist do not adequately protect the debtor, spouse, and dependents and recommends uniform exemptions to ensure the necessaries of life to the debtor and the debtor's family.

Contacting Third Parties

While communication of the existence of an alleged debt to a person other than the debtor is not, strictly speaking, a creditors' remedy, the Commission considered it because of its extensive use as a collection practice. To the Commission's surprise, almost 48 percent of all creditors surveyed estimated that they contacted employers and other persons, including neighbors, from 1 to 40 percent of the time to assist in debt collection activities. Threats to job security and application of social pressure are not proper methods to induce payment of debt. Until such time as a debt has been reduced to judgment, it should be a private matter between the debtor and creditor. Any communication regarding a debt to the debtor's employer or neighbors or others without the debtor's consent is an invasion of the debtor's privacy and is not a legitimate collection practice.

This recommendation in no way is intended to prohibit a creditor from reporting appropriate information about a debt or alleged debt to a credit bureau, or from employing an agent or attorney to collect the debt.

No creditor or agent or attorney of a creditor before judgment should be permitted to communicate the existence of an alleged debt to a person other than the alleged debtor, the attorney of the debtor or the spouse of the debtor without the debtor's written consent.

Miscellaneous Recommendations

Several collection devices and contract provisions either were not included in the *Survey* or were included only in questionnaires to certain creditors. Recommendations regarding these provisions and devices are based on grounds of public policy and fair dealing and limited empirical data which the Commission had available.

Balloon Payment

With respect to a consumer credit transaction, other than one primarily for an agricultural purpose or one pursuant to open end credit, if any scheduled payment is more than twice as large as the average of earlier scheduled payments, the consumer should have the right to refinance the amount of that payment at the time it is due without penalty. The terms of the refinancing should be no less favorable to the consumer than the terms of the original transaction. These provisions do not apply to a payment schedule which, by agreement, is adjusted to the seasonal or irregular income of the consumer.

The "balloon payment" presents a potentially serious problem for the consumer. If a consumer signs a $2,000 note payable in 11 instalments of $150 and a final instalment of $350, such a payment schedule could lull him into a pattern of $150 payments. When the final $350 payment comes due the consumer may not have properly budgeted for this payment, leaving him the choice of defaulting or of refinancing the balance due. Under such pressure, the debtor is most susceptible to an increase in the APR on the balance. In many cases, a balloon payment is simply a device to encourage the refinancing of some portion of a debt often at a rate in excess of the original rate. The Commission recommends restriction of balloon payments except when they are *bona fide* attempts to arrange payment schedules to meet the needs of consumers earning irregular incomes.

Co-Signer Agreements

No person other than the spouse of the principal obligor on a consumer credit obligation should be liable as surety, co-signer, co-maker, endorser, guarantor, or otherwise assume personal liability for its payment unless that person, in addition to signing the note, contract, or other evidence of debt also signs and receives a copy of a separate co-signer agreement which explains the obligations of a co-signer.

The Commission surveyed use of co-signer agreements by finance companies and credit unions only. Both types of institutions placed some reliance on the co-signer agreement as a method of collection, but credit unions virtually always included such agreements in their contracts and relied on them as a collection device to a greater extent than did finance companies. A creditor's reference to the liability of a co-signer is often effective in inducing the primary obligor on the contract to satisfy the obligation irrespective of the underlying merits of the claim.

To protect persons who obligate themselves as co-signers and provide them information necessary for full

496-072 O - 73 - 5

understanding of their obligation, the Commission recommends that co-signers be required to execute separate co-signer agreements similar to the form required by the Wisconsin Consumer Act, and that the creditor be required to furnish a copy of that agreement to each co-signer. The Wisconsin form reads:

> (a) The undersigned as a co-signer or guarantor has agreed to pay the total of payments under a consumer credit transaction between ____________ (name of customer) and ____________ (name of merchant) made on ____________ (date of transaction) for ____________ (description of purpose of credit, i.e., sale or loan) in the amount of $ ______ .
>
> (b) As a co-signer the undersigned will be liable and fully responsible for payment of the above amount even though he is not entitled to any of the goods, services or loan furnished thereunder.
>
> (c) The undersigned may be sued in court for the payment of the amount due under this consumer credit transaction even though the customer named above may be working or have funds to pay the amount due.
>
> (d) This explanation is not the agreement under which you are obligated, and the guaranty or agreement you have executed must be consulted for the exact terms of your obligations.
>
> ____________________
> (signature of co-signer)

Rebates for Prepayment

A consumer should always be allowed to prepay in full the unpaid balance of any consumer credit obligation at any time without penalty. In such instances the consumer should receive a rebate of the unearned portion of the finance charge computed in accordance with the "balance of the digits" (otherwise known as "sum of the digits" or "rule of 78's" method) or the actuarial method. For purpose of determining the instalment date nearest the date of prepayment, any prepayment of an obligation payable in monthly instalments made on or before the 15th day following an instalment due date should be deemed to have been made as of the instalment due date, and if repayment occurs on or after the 16th it should be deemed to have been made on the succeeding instalment due date. If the total of all rebates due the consumer is less than $1 no rebate should be required.

In the event of prepayment the creditor should not be precluded from collecting or retaining delinquency charges on payments due prior to prepayments.

In the case of credit for defective goods, the consumer should be entitled to the same rebate as if payment in full had been made on the date the defect was reported to the creditor or merchant.

If the maturity of a consumer credit obligation is accelerated as a result of default and judgment is obtained, or a sale of secured property occurs, the consumer should be entitled to the same rebate that would have been payable if payment in full had been made on the date judgment was entered or the sale occurred.

Upon prepayment in full of a consumer credit obligation by the proceeds of credit insurance, the consumer or his estate should be entitled to receive the same rebate that would have been payable if the consumer had prepaid the obligation computed as of the date satisfactory proof of loss is furnished to the company.

The Commission believes consumers ought to be allowed to prepay consumer credit obligations in full at any time without being subjected to a penalty for such prepayment. Finance charges earned through the date of full prepayment should, of course, be retained by the creditor, but any excess should be refunded to the customer without penalty or deduction.

Both the balance of the digits and the actuarial method of rebate computation take into account both the *amount* of credit available to the debtor and the *time* he has had use of the funds. For example, if a debtor borrows $1,200, with a finance charge of $72, repayable in 12 monthly instalments of $106, his use of the proceeds of that loan is as follows:

Month	*Dollar Months of Use*
1st	1,200
2nd	1,100
3rd	1,000
4th	900
5th	800
6th	700
7th	600
8th	500
9th	400
10th	300
11th	200
12th	100
	7,800

If he should prepay the loan at the end of the 4th month, the debtor would have had the use of 4200 dollar months (1,200 + 1,100 + 1,000 + 900) out of a total of 7,800 dollar months. Under the balance of the digits method, the creditor would be entitled to retain 42/78 of the initial finance charge, and the debtor would receive a refund of 36/78 of that charge. In this example, the refund to the debtor would be

$$36/78 \times \$72 = \$33.23$$

The actuarial method, while computed from actuarial tables, produces approximately the same result. In the

same example a refund under the actuarial method would amount to $33.63, a difference of only 40 cents. If the debtor had paid the loan in full after the first month, the refund due him under the balance of the digits method of computation would have been $60.92 and under the actuarial method $61.10.

In view of the negligible difference between results of the two methods, and in view of the existing extensive use of balance of the digits refund tables, the Commission recommends the use of either method.

The Commission takes the position that the amount of the refund is a function of the gross amount of the precomputed finance charge, irrespective of whether that finance charge was computed by application of a single rate or application of graduated rates (e.g., 36 percent on the first $300 and 24 percent on the balance). That is, the refund should be computed on the basis of the total precomputed finance charge and the total amount being prepaid so that, after rebate of the unearned finance charge to the debtor, the effective rate earned by the creditor approximates the disclosed APR.

If goods are defective, the Commission feels quite strongly that the debtor should be entitled to a rebate of all finance charges from the date the defect is reported to either the financing institution or the seller. It is patently inequitable to exact a finance charge in connection with a credit purchase of goods if the consumer is denied use of the goods because of a defect.

Entry of judgment against the debtor and payment of the obligation from proceeds of an insurance policy have the same effect as prepayment of the obligation as of the date the judgment is entered or proof of loss is furnished. Finance charges are not earned by the creditor after these events, and the debtor should be entitled to rebate of the unearned portion of those charges.

Unfair Collection Practices

The Commission recommends abolition of the following additional collection techniques without hesitancy.

Harassment

No creditor, agent or attorney of the creditor, or independent collector should be permitted to harass any person in connection with the collection or attempted collection of any debt alleged to be owing by that person or any other person.

Harrassment includes, but is not limited to, the following practices:

1. Threats of violence, express or implied, to the person or property of any person, or threats to impair the consumer's credit standing.
2. False statements or intimations to any person that a debtor is unwilling or refuses to pay a just debt.
3. Placing telephone calls at unusual times or times known to be inconvenient, or continuous placing of calls and repeated engagement of persons in conversation.
4. Use of obscene or profane language.
5. Threatening to cause the loss of the consumer's employment; requesting the consumer's employer to require the consumer to pay; making continuous personal visits to the consumer at his place of employment so as to interfere with his employment function.

In the Commission's view, the above practices are offensive to the conscience of society and should not be permitted to occur.

Sewer Service

If a debtor has not received proper notice of the claim against him and does not appear to defend against the claim, any judgment entered shall be voided and the claim reopened upon the debtor's motion.

The systematic practice by process servers (usually private process servers) of filing an affidavit of service on the defendant-debtor when, in fact, the summons has never been served but stuffed in a "sewer" or elsewhere, should not be allowed to continue. The practice denies the debtor-defendant proper notice and an opportunity to defend the underlying claim against him.

Inconvenient Venue

No creditor or holder of a consumer credit note or other evidence of debt should be permitted to commence any legal action in a location other than (1) where the contract or note was signed, (2) where the debtor resides at the commencement of the action, (3) where the debtor resided at the time the note or contract was made, or (4) if there are fixtures, where the goods are affixed to real property.

Many states permit a suit for money judgment to be brought in a county where either the plaintiff or defendant resides. This type of venue provision can easily be abused by plaintiffs in collection matters. For example, if the plaintiff-creditor has multiple locations or a central place of business fairly distant from the county or location where most of its customers reside, it can initiate suit in a venue (location) which, though "legally" proper, is extremely distant from or inconvenient to the debtor-defendant. The practice usually results in the entry of a default judgment and, in effect deprives the debtor-defendant of a reasonable opportunity to defend against the underlying claim. The Commission believes the plaintiff-creditor should be able only to initiate action in locations convenient to the

debtor-defendant or in locations where reasonable grounds exist on which to base the debtor-defendant's appearance.

Debtors in Distress

Consumer Credit and Consumer Insolvency

Almost concurrently with the Commission study, the Commission on Bankruptcy Laws of the United States has been studying, analyzing, and evaluating the technical aspects of the Bankruptcy Act as they "are interwoven with the rapid expansion of credit . . ."[80] This Commission, however, feels compelled to address itself to areas of consumer credit directly related to the bankruptcy process.

Perhaps the concept most fundamental to the Bankruptcy Act is "rehabilitation" of the bankrupt. Lightening the load of debts is inherent in any rehabilitative scheme, but, it is questionable whether the existing bankruptcy system affords the consumer-bankrupt adequate opportunity for rehabilitation.

Often the existence of one debt out of proportion to others or incurred because of deceptive sales practices precipitates bankruptcy. Current alternatives of "straight" bankruptcy or a Chapter XIII - Wage Earner Plan may not solve the debtor's dilemma. He may wish to pay all of his debts except one fraudulently incurred. Or he may wish to be able to be discharged from all his obligations but may subsequently find himself unable to obtain credit except from a creditor who wants him to reaffirm his prior debt as a condition for granting new credit.

The Commission believes that Chapter XIII of the Bankruptcy Act can be better utilized. While no inference should be drawn that the Commission is in favor of "compulsory" Chapter XIII in consumer bankruptcy situations, it believes that the bankruptcy courts can play an integral role in the consumer credit system by providing counseling for the debtor[81] and by helping to resolve debtor-creditor problems which are particularly acute in our credit-oriented society.

The Commission recommends:

The expansion of Chapter XIII of the Bankruptcy Act as endorsed by the House of Delegates of the American Bar Association in July 1971, whereunder Chapter XIII courts, under certain circumstances, would be permitted to alter or modify the rights of secured creditors when they find that the plan adequately protects the value of the collateral of the secured creditor.[82]

In petitions for relief in bankruptcy the bankruptcy court should disallow claims of creditors stemming from "unconscionable" transactions.

Bankruptcy courts should provide additional staff to serve as counselors to debtors regarding their relations with creditors, and regarding their personal, credit, and domestic problems.

The Commission believes that Chapter XIII ought to be opened to persons other than just wage earners. Chapter XIII is an effective device for encouraging debtors to pay their debts rather than to seek a discharge in bankruptcy. In many instances Chapter XIII relief offers the debtor more lasting benefits than he would receive in "straight" bankruptcy and helps the debtor avoid the "stigma" of being adjudicated a bankrupt.

In determining whether a consumer credit transaction is unconscionable, the bankruptcy court, in addition to case law, should consider whether the transaction entailed an "improvident extension of credit." The court should, in fact, consider whether the creditor made "an extension of credit to a debtor where it cannot be reasonably expected that the debtor can repay the debt in full in view of the circumstances of the debtor as known to the creditor and of such circumstances as would have been revealed to him upon reasonable inquiry prior to the credit extension."[83]

If the bankruptcy court were empowered to disallow "unconscionable" debts, the bankrupt in his initial petition need not elect between straight bankruptcy and a wage earner plan under Chapter XIII, but may just file application for unspecified relief together with schedules listing debts and assets. After court review of facts surrounding the extension of credit, the debtor and his attorney could consult with the court-appointed counselor and discuss advantages and disadvantages of straight bankruptcy or a Chapter XIII plan.

The court appointed counselor could also play a vital role in any decision of the debtor regarding reaffirmation of a debt affected or discharged by a Chapter XIII or straight bankruptcy plan. Since creditors frequently attempt to obtain reaffirmation of a debt discharged or affected by a bankruptcy plan,[84] it would be the counselor's function to explain the implications of reaffirmation to the debtor. However, beyond informing the debtor of his or her rights and/or obligations, the counselor should have no active role in the decision of whether or not to reaffirm.

Liability of Corporate Officers

The consumer credit market continues to grow, unfair practices continue to be used in that market, particularly in low income areas, and the Commission perceives an acute necessity for breaking down the protective barriers which the corporate veil affords the unscrupulous merchant and creditor. The debtor may often find himself with an award for damages against a

corporation which has been dissolved or is insolvent. The officers, directors, and managers of such corporations, the individuals who knowingly and wilfully perpetrated deceptions on the consumer, should be responsible for the consequences of their acts. They should not be able to hide behind the shield of the corporation.

Door-to-Door Sales

In any contract for the sale of goods entered into outside the creditor's place of business and payable in more than four instalments, the debtor should be able to cancel the transaction at any time prior to midnight of the third business day following the sale.

In this recommendation the Commission accepts the definition of "consumer credit" contained in regulation Z section 226.2(k). Recognizing that in a significant portion of sales occurring outside the creditor's place of business, the debtor may be induced to sign a sales agreement by high pressure techniques, the Commission believes that many consumers become unwilling participants to the agreement and should be afforded a reasonable opportunity to cancel the agreement.

Assessment of Damages

If a creditor in a consumer credit transaction obtains a judgment by default, before a specific sum is assessed the court should hold a hearing to establish the amount of the debt the creditor-plaintiff is lawfully entitled to recover.

Survey of Consumer Credit Collection Practices and Creditors' Remedies

The Commission *Survey* of all segments of the consumer credit industry was undertaken with four objectives:

First: To help the Commission understand practices normally used in debt collection by all segments of the industry;

Second: to compile data establishing the extent and frequency of use of various alternative collection practices, creditors' remedies, and contract provisions;

Third: to document and compare experiences of various creditors and to further compare experiences of creditors in states which have restricted or abolished certain collection devices with experiences of creditors in those states which have taken no such action; and

Fourth: to help the Commission determine what collection practices, creditors' remedies, and contractual provisions are most effective in achieving payment of legitimate debt with the least burden on the debtor and the creditor.

The following exhibits are summaries of creditor responses to questions 8, 9, 12 and 16 of the *Survey*. These exhibits deal respectively with the major reasons for default, grace periods, collection procedures and third party contracts.

EXHIBIT 3-1

MAJOR REASONS CREDITORS CITE FOR DEBTOR FAILURE TO MEET CONTRACTUAL TERMS

(Analysis of Q.8)

REASON	BANKS	FINANCE COMPANIES	RETAIL TRADE
Unemployment	1	1	1
Overextension	2	2	3
Illness of debtor	3	3	2
Separation	4	4	4
Illness of family member of debtor	5	6	6
Divorce	6	5	5
Lack of intention to repay just debt-"deadbeat"	7	8	7
Family relocation	8	7	8

EXHIBIT 3-2

CREDITOR GRACE PERIOD BEFORE CONSUMER ACCOUNT HELD DELINQUENT

(Analysis of Q.9)

	BANKS	FINANCE COMPANIES	RETAIL TRADE
Number of days before creditor declares a consumer credit account delinquent.	12.2	16.5	39.4

EXHIBIT 3-3

MOST EFFECTIVE COLLECTION PROCEDURES OTHER THAN LEGAL ACTION

(Analysis of Q. 12)

	BANKS	FINANCE COMPANIES	RETAIL TRADE
Percentage of creditors listing telephone communication among the most effective	52	52	70
Percentage of creditors listing personal contact among the most effective	53	51	28
Percentage of creditors listing letter communication among the most effective	28	25	44
Percentage of creditors listing referral to collectors among the most effective	7	6	22
Percentage of creditors listing refinancing of the obligation among the most effective	5	4	15

EXHIBIT 3-4

CONTACT OF THIRD PARTIES IN EFFORT TO COLLECT CONSUMER CREDIT OBLIGATIONS

(Analysis of Q.16)

	BANKS					FINANCE COMPANIES			RETAIL TRADE	
	OCG Direct	OCG Indirect	Auto Direct	Auto Indirect	Personal Loans	Auto Direct	Auto Indirect	Personal Loans	Revolving	Instalment
Percentage of creditors who telephone debtor's employer	59	55	57	59	56	57	55	49	33	28
Never - 0%	34	34	33	32	34	34	33	38	60	61
Rarely 1-15%	49	49	50	52	48	54	52	46	30	26
Occasionally, 16-40%	6	4	6	7	7	1	2	2	3	1
Often 41-70%	.5	.9	.5	.5	.9	0	0	0	0	0
Usually 71-100%	.2	.3	.3	.2	.4	1	2	.5	0	0
Percentage of creditors who telephone neighbors and others	41	40	40	43	39	46	46	41	29	29
Never - 0%	48	47	48	48	49	41	45	44	62	57
Rarely 1-15%	36	35	35	38	34	39	37	35	24	28
Occasionally 16-40%	4	4	4	4	4	4	6	5	3	1
Often 41-70%	1	.9	.8	.9	.8	1	3	.5	2	0
Usually 71-100%	.3	.3	.4	.4	.3	1	0	.5	0	0

Chapter 4

SUPERVISORY MECHANISMS

INTRODUCTION

The Commission considered at length the adequacy of Federal and state supervisory and regulatory mechanisms to protect the public from unfair consumer credit practices. For the most part, consumer credit protection laws require disclosure of credit costs, regulate rates of credit charges, limit terms of credit agreements, and restrict practices used by creditors to enforce these agreements.[1] Though a large body of consumer law has evolved during recent decades, public discontent with credit problems seems to have risen rather than decreased during this period of extensive legislative activity. A partial explanation of this phenomenon can be attributed to unsuccessful enforcement of these laws.

In its broad sense, effective enforcement of consumer credit laws must encompass (1) educating the consumer on how to stay out of trouble; (2) informing the consumer of his legal rights under the law; (3) preventing creditors from abusing consumers; and (4) aiding the aggrieved consumer once he has been injured. Most formal enforcement procedures have focused on the third function of enforcement–supervising and inspecting creditors to deter them from violating credit laws–while human relations aspects of the first and fourth functions have been neglected. Since consumer education is discussed in Chapter 11 and legal rights in Chapter 3, this chapter deals only with the second and third functions of enforcement.

From a consumer's standpoint there is no persuasive reason why the governmental role in enforcing his rights under credit laws cannot be performed in a uniform, consistent manner by a minimum number of different agencies. However, governmental mechanisms for protecting consumers in the credit arena are incredibly diverse. Two planes of variables contribute to the confusion. First, some creditors are extensively regulated for consumer credit purposes while others are scarcely touched by regulatory agencies. Second, some creditors are regulated by Federal authorities, some by state authorities, some by both, and some, in truth, by neither.

Much of the complexity in the enforcement of consumer credit laws today stems from two major features of American economic life. The first is the dua banking structure which encompass a national bankin system with a strong tradition of independence fron state control. The second is the existence in most state of usury laws with such low rate ceilings that mos creditors could not take the risks of granting credit tc consumers without exceptions from the usury laws.

Under the dual banking system national banks are regulated only by Federal authorities and, virtually, only for compliance with Federal laws (violation of state usury laws was expressly made a violation of Federal law). Later, other federally chartered institutions came into existence–savings and loan associations, credit unions–similarly independent of state control. Until passage of the Consumer Credit Protection Act (CCPA) in 1968,[2] nearly all consumer credit protection law was state law. Hence, the insulation of federally chartered institutions from state control meant that much consumer credit law had little impact on Federal institutions because Federal authorities were largely uninterested in examining for violations of state laws. State officials were thought to have only limited rights to impose these laws on Federal institutions.

Because consumer finance companies could not extend consumer credit profitably under usury laws, they appealed to state legislatures for exemption from such laws. Their bid for higher rates was presented to the public and lawmakers as sponsorship of anti-loan sharking laws, for the dearth of legitimate consumer loans had left the small loan market to illegal lenders.[3] The price consumer finance company lenders paid for the privilege of charging rates higher than allowed by usury laws was to submit to licensing and heavy administrative control. The consumer finance industry is still the most heavily regulated segment of the consumer credit industry.

In contrast, retailers which began extending instalment credit were shielded from usury laws by the judge-made "time price" doctrine. This doctrine permitted the sale of an article for $100 cash or for a "time price" of $110 to be paid over 10 months without the $10 being considered interest under the usury laws.[4] Consequently, retailers needed no legislative authorization to grant consumer credit at profitable rates and came under no substantial legislative supervision until

passage of the retail instalment sales acts after World War II. By then retail consumer credit was a mature industry. Whether because of tradition or its enormous size, in most states retail credit has not been brought under administrative control similar to that imposed by the Uniform Consumer Credit Code (UCCC). One of the more controversial innovations of the UCCC—promulgated by the National Conference of Commissioners on Uniform State Laws in 1968 and enacted in six states by 1972, is its subjection of all retailers to a substantial degree of administrative control.

In summary, largely for historical reasons, credit consumers may find skilled administrative personnel assuring them of their statutory rights when they borrow money from a licensed lender. But when they buy goods from a retailer for a comparable finance charge, they generally find most governmental agencies uninterested if they have problems and are left to assert their rights by private suit against the creditor. Similarly, for reasons rooted in the historical development of the dual banking system, national bank depositors are guaranteed by supervisory personnel that the bank remain solvent, but those who obtain a consumer loan from the same bank find that supervisory officials have little or no interest in having that bank comply with state consumer protection laws. Here again the debtor is left to assert private suit against the bank.

CONSUMER CREDIT GRANTORS AND THE ENFORCEMENT MECHANISM

Because historically new credit grantors entered the market intermittently and credit legislation emerged on a piecemeal basis, the consumer credit industry has become highly segmented. Banks, consumer finance companies, credit unions, retailers, and sales finance companies perform somewhat different functions and often are not permitted to compete effectively with each other. To say that the laws protecting the public in dealing with these creditors grew along segmented lines is to state only half the truth, because, the laws were largely responsible for the segmentation. Even though many credit suppliers have diversified and now participate in different segments of the industry, the legal walls of segmentation still stand.

Deposit Holding Lenders

Commercial and savings banks, savings and loan associations, credit unions, and some industrial banks are both consumer credit grantors and recipients of deposits. The basis of governmental supervision of deposit holding institutions has traditionally been that of guarding against failure.[5] Thus the great body of law that has developed concerning these institutions has been principally concerned with preserving their solvency for the benefit of depositors. Restrictions are commonly placed on the kinds, amounts, and terms of loans they can make, and they are periodically examined for possible fraud or defalcations. Since the 1930's, depositors have enjoyed the additional protection of federally sponsored deposit insurance.

Governments have been loath to rely on competitive market forces to protect the public in dealing with depository institutions. Each type of institution is chartered or licensed by governmental officials with particular interest in the institution's capacity to operate successfully, and, therefore, with interest in the financial fitness and moral character of those seeking the charter or license. Chartering power has been used to limit the number of banks and savings and loan associations permitted in the market to whatever number of qualified participants the authorities deem appropriate to meet community needs.

For the most part, supervision over deposit holding institutions is exercised by chartering, licensing, or insuring authorities. Threat of revocation or suspension of charter or license is considered adequate to compel compliance with the supervisory agency's regulations and applicable law.[6] Until recently, private suits against banks and savings and loan associations for violations of governmental regulations have been comparatively rare, for the individual depositor's rights are enforced for him by the supervisory agency on the theory that the public—the depositors—"could not and/or should not look after its own interests."[7] In addition to its examination function, much of a supervisory agency's activities are instructional and supportive, such as establishing rules and guidelines to help institution personnel comprehend and comply with the law.

Nondeposit Holding Lenders

Consumer finance companies are the leading nondeposit holding consumer lenders. Before development of licensed consumer finance companies between 1910 and 1930, the loan shark was probably the most common source of credit for the wage earner. Loan sharking prospered because legitimate lenders could not profitably lend to consumer borrowers under the low usury law ceilings.[8] Social conditions were ideal from about 1880 to 1920 for illegal lenders to flourish, as the rural exodus to urban America heightened demands for consumer loans. Since commercial banks were unwilling to enter the consumer credit market, either because of their tradition of lending to commercial institutions or because consumer loans at permissible rates were unprofitable, urban America became the illegal lender's paradise.

As early as 1905 the Russell Sage Foundation set out to attract responsible capital into the consumer finance field where regulated lenders could make small loans available to borrowers at reasonable rates. This movement culminated in 1916 in the first draft of the Uniform Small Loan Act which allowed licensed lenders to charge rates substantially in excess of the usury laws for loans of small amounts. Successive drafts of the Act moved away from free market competition as a protective force and toward stricter supervisory and regulatory controls in the form of periodic examination of a licensee's activities to ensure his compliance with statutory loan size limits, rate ceilings, and prepayment refunds. The first draft provided that licenses should be granted to all who demonstrated financial fitness and good moral character. By the fifth draft, freedom of entry was abandoned by allowing licensing officials to restrict licenses to lending offices which were "to the convenience and advantage of the community"—a vague and never-defined term which, predictably, was interpreted with widely differing results in various jurisdictions.[9]

Because consumer finance companies have no depositors, their administrative supervision is directed toward protecting the consumer borrower. Periodic examinations are required, and annual reports are prescribed. It is fair to say that in most states operations of consumer finance companies are intensively supervised by administrative officials charged with enforcing small loan laws. Supervisory agencies take pride in compelling refunds to consumers of even the smallest overcharges.

A basic premise of small loan laws has been the concept of the "all-inclusive" finance charge—for rate ceilings purposes the consumer finance company must include in the finance charge all, or almost all, charges imposed on the debtor as a condition of obtaining credit. This is in sharp contrast to the legal position of another class of lender, often referred to as the "second mortgage lender" because of their custom of taking junior security interests in real property. Favorable judicial decisions allowed second mortgage lenders to make substantial credit-related charges which were not considered interest under the usury laws. In effect, second mortgage lenders could exact credit charges as high or sometimes higher than those imposed by licensed lenders. In many states they can still do so with no administrative supervision. Thus, the borrower seeking a personal loan may be presented with an astonishing choice: he can borrow from a licensed lender and enjoy heavy administrative protection, or he can borrow the same amount of money on the security of his home at a rate as high or higher from an unregulated lender. The consumer's only remedy for an overcharge in the latter case may be to hire a lawyer and bring a private law suit to attempt to show a violation of the state usury law.

Retailers and Their Assignees

Had the courts decided that usury laws were intended to apply to sales credit as well as loan credit, credit selling might have become as highly regulated as the consumer finance industry. However, the "time-price doctrine" enabled sellers to offer instalment credit without seeking legislative exemption from usury laws. So long as the time-price doctrine went unchallenged for retail instalment sales, sellers had little need for legislation in the credit area. In most states, legislation on vendor, unlike that on lender, credit was a long time in coming. Not until the late 1940's when credit selling had already become a mature business did credit legislation begin to appear in volume.[10]

Early statutes were legislative reactions to specific abuses. The first to receive widespread legislative attention was the failure of some sellers to make adequate disclosure of significant aspects of retail instalment credit sales. In some cases the buyer might not have been told the total amount he owed, might not have received a copy of the contract he signed, or he might have signed a substantially blank contract. Lack of disclosure enabled the unscrupulous seller to burden the buyer with exorbitant credit charges. Because of the relative size and importance of consumer credit extended to finance automobile sales, the first retail instalment sales acts were almost entirely devoted to motor vehicle transactions. They usually required that the contract clearly disclose all terms of the agreement and that the buyer be given a copy of the contract. Certain unfair contract provisions were expressly prohibited; the seller was forbidden to allow the buyer to sign a contract containing blank spaces; and some, but not all, set rate ceilings. A number of states enacted similar statutes to cover instalment sales of goods other than motor vehicles—the so-called "all-goods" acts. As retail selling continued to grow and additional abuses appeared, several states enacted more detailed instalment sales acts to deal specifically with problems arising from insurance, add-on or consolidated sales, unfair contract provisions, the transferee's position in relation to the buyer, default and deferral charges, and refinancing.

At present the crucial difference in enforcement of legislation between lenders and retailers is the degree of administrative control. As already noted, lenders such as banks and consumer finance companies have been subjected to chartering or licensing with substantial administrative supervision, some directed at protecting depositors and shareholders (banks, credit unions) and

some at protecting consumer-borrowers (consumer finance companies). But retail credit statutes normally vest no administrative officer with power to supervise or examine credit sellers.

Violations of the typical retail instalment sale act are met only by penalties (*e.g.*, twice the amount of the finance charge) that an aggrieved consumer may obtain by bringing a private law suit against the creditor.[11] The absence of any administrative control on behalf of the consumer means that retail credit laws are largely enforceable only by the victims of those who violate these laws. Surely legislators cannot expect consumers who are so poor and ingenuous as to be victimized in credit sales transactions to be wealthy and sophisticated enough to initiate and fight a lawsuit to a successful conclusion against usually well-financed creditors. One of the first statutes to propose administrative control of credit sellers is the UCCC which, at present, has been enacted in Colorado, Idaho, Indiana, Oklahoma, Utah and Wyoming.[12]

Motor vehicle and appliance dealers commonly discount their consumer contracts with sales finance companies or commercial banks. More than half the states have some form of licensing for sales finance companies. These acts usually define a sales finance company as one engaged in acquiring instalment contracts from retailers. Two differences distinguish licensing of sales finance companies from that of consumer finance companies. In sales finance licensing the convenience and advantage test is not used to limit the number of participants, and administrative supervision is lighter than that imposed on consumer finance licensees.

Some acts set character standards for sales finance licensees. Banking institutions and other supervised lenders are often specifically exempted from coverage. Annual reports and mandatory yearly inspections usually are not required. The administrator is given investigatory and subpoena powers to determine whether licensees are violating the instalment sale acts. Aggrieved buyers can file written complaints with the administrator detailing alleged violations and the administrator can investigate these complaints and hold hearings. The administrator can usually suspend or revoke the license issued under the statute if the licensee has knowingly or without exercise of due care violated the instalment sale act.

In several states a retailer is covered by the sales finance company licensing act if he retains a given dollar amount of his instalment paper. For instance, the New York act defines "sales finance company" as including "a retail seller of motor vehicles engaged, in whole or in part, in the business of holding retail instalment contracts acquired from retail buyers, which have aggregate unpaid time balances of twenty-five thousand dollars or more at any one time . . . ." In a few states a retailer may be considered a sales finance company without regard to dollar amounts if he retains his own paper.

SUPERVISORY FUNCTIONS OF FEDERAL AND STATE AGENCIES

Most consumer credit is held by creditors currently subject to supervision in some form. To determine whether existing supervisory and regulatory mechanisms are adequate to protect the public from unfair practices and insure the informed use of consumer credit, the Commission studied the supervisory functions of major Federal and state agencies having jurisdiction over extenders of consumer credit. First, the Commission considered those functions which historically have been the *primary* concern of the regulators. Then it attempted to determine whether the various Federal and state supervisors were willing and able to examine for compliance with and to enforce consumer credit protection laws. Although the Commission avoided assessing the adequacy of *general* supervision over financial institutions, it was still necessary to look into it, because consumer credit protection activities are almost always a part of the general supervisory and examination function. However, its resultant findings and recommendations are restricted to the special area of consumer credit protection.

Federal Agencies

Office of the Comptroller of the Currency

In 1863 Congress passed the National Currency Act which created the national banking system and established the Office of the Comptroller of the Currency. That Act was superseded the following year by the National Bank Act which continued the national banking system administered by the Comptroller. The Comptroller's office has authority to grant charters to national banks, authority to issue regulations to provide for "the proper regulation and supervision of the operations of national banks,"[13] and the responsibility to examine every national bank twice in each calendar year.[14]

On June 30, 1971, the Comptroller's office had administrative and supervisory responsibilities over 4,599 banks with 12,946 branches. Although the Comptroller's supervisory responsibilities applied to a minority of the total number of banks in the country, those banks accounted for approximately 60 percent of all commercial bank deposits. National banks, as of June 30, 1971, had approximately $183.7 billion outstanding in all

types of loans. Of this amount approximately $40.7 billion was outstanding in direct and indirect consumer credit, including credit card transactions.

At the heart of the Comptroller's power to charter banks is the concomitant power to examine to ensure that the bank's activities are conducted in a safe and sound manner in compliance with applicable law and with the Comptroller's Regulations and Rulings. This view is succinctly expressed on page 1 of the Comptroller's Handbook of Examination Procedure:

> All facets of bank examination, ranging from appraising assets and internal controls to evaluating the soundness of management policies, have as their end result the determination of liquidity and solvency—present and prospective—and the legality of the bank's acts.

First Deputy Comptroller of the Currency, Justin T. Watson, stated at Commission hearings in June 1971 that the Comptroller's office "since 1913 has been primarily concerned with the protection of the liquidity and solvency of the country's national banks."

In addition to authority to examine every phase of a national bank's activities, the Comptroller's office has the extraordinary power to issue cease and desist orders under the Financial Institutions Supervisory Act of 1966.[15] These orders, after notice of charges and a hearing, may issue if in the Comptroller's opinion the national bank:

> is engaging or has engaged, or the agency has reasonable cause to believe that the bank is about to engage, in an *unsafe* or *unsound practice* in conducting the business of such bank, or is *violating or has violated,* or the agency has reasonable cause to believe that the bank is about to *violate,* a *law,* rule, or regulation, or any condition imposed in writing by the agency in connection with the granting of any application or other request by the bank, or any written agreement entered into with the agency . . . . (emphasis added).

This extraordinary grant of power also enables the Comptroller's office to suspend or remove a director or an officer of a national bank for cause.

The force behind the supervisory and administrative activities of the Comptroller is the specter of loss of *charter,* loss of insurance, and loss of membership in the Federal Reserve System unless the bank complies with all applicable laws, rules and regulations.

Federal Reserve System

In addition to its primary functions of developing and implementing monetary policy and management, and addressing itself to problems of international banking and finance, the Board of Governors of the Federal Reserve System (FRB) is also a bank regulatory agency, empowered to examine the accounts, books and affairs of each of the 12 Federal Reserve Banks and each member bank. The FRB, either directly or through the Federal Reserve Banks, performs other activities, such as discounting, currency issue and redemption and clearing house functions.

All national banks are required to be members of the Federal Reserve System, but state bank membership is elective. If a state bank wants to become a member, it must satisfy certain reserve and capital requirements and purchase stock in their district Federal Reserve Bank. Once admitted into the Federal Reserve system such banks are known as "state member banks" and are automatically admitted as members of the Federal Deposit Insurance Corporation.

The fundamental statutes governing the chartering of state member banks are of state origin. Nevertheless, the activities of the banks are significantly affected by Federal laws and FRB regulations, with which compliance is a condition of Federal Reserve System membership.

On June 30, 1971, 1,138 state member banks with 3,713 branches held approximately one-fourth of all commercial banks deposits and had approximately $65.3 billion outstanding in loans and approximately $11.4 billion outstanding in direct and indirect consumer credit, including credit card transactions. The FRB has supervisory responsibility over fewer banks than the two other Federal bank regulatory agencies, but many of these are large banks in major financial centers. The average size of a bank subject to FRB supervision is considerably larger than the average bank under FDIC supervision.

State member banks are subject to supervision and examination by the state which chartered the bank as well as by the FRB. Although national banks are also members of the Federal Reserve System, dual examinations are avoided because the FRB defers to the Comptroller for examination.

Most of the examination functions of the FRB are carried out by the 12 Federal Reserve Banks, where the principal concern like that of the Comptroller is to maintain a safe and sound banking system. The FRB, like the Comptroller's office, has extraordinary power to issue cease and desist orders and to remove officers or directors. A major reason for passage of the Federal Reserve Act in 1913 was "to establish a more effective supervision of banking."[16]

Federal Deposit Insurance Corporation

The Federal Deposit Insurance Corporation (FDIC) was created by Congress in an amendment to the Federal

Reserve Act by the Banking Act of 1933,[17] "to promote the soundness of banking and to aid the government in discharge of its fiscal transactions."[18] Its primary function is to "insure. . .the deposits of all banks which are entitled to the benefits of insurance under this chapter. . . ."[19] The FDIC has fulfilled its legislative purpose by protecting bank depositors and maintaining public confidence "in the Nation's money supply in the event of bank failure."[20] A paper prepared by George J. Benston of the University of Rochester for the President's Commission on Financial Structure and Regulation indicated that the average annual number of banks closed per 100 banks operating at the beginning of the year went from .32 between 1934 and 1942 to .041 between 1963 and 1970.[21] Similarly, the annual average loss on deposits per $100 of deposits in operating insured banks at the beginning of the year declined from $.0060 between the 1934 and 1942 period to $.0010 between 1963 and 1970.[22]

A report prepared by Carter Golembe for the National Association of Supervisors of State Banks, also attested to the FDIC's excellent record in protecting the public against bank failure. It noted that:

> Within the last several decades the FDIC has taken on more of the coloration of a bank supervisory agency because of the fact that its insurance activities (though not its responsibilities) have dwindled to insignificant proportions. With bank failures during the past decade averaging less than 6 per year (compared, say, with approximately 500 per year during the 1920's) the insurance operations of the FDIC—while still of immense importance to individuals and communities concerned—do not bulk large in that agency's activities.[23]

Indeed, the 1971 Annual Report of the FDIC disclosed that on December 31, 1971, less than 9 percent of all employees were involved in the Division of Liquidation and that 1,908 of all 2,607 employees were utilized by the Division of Examination.[24] Since its establishment nearly 40 years ago, the FDIC's examination function, initially only incidental to its major insurance function, has become the agency's predominant activity.

State nonmember banks (non-Federal Reserve members) may apply to the FDIC for insurance coverage. If certified for insurance, they are known as insured state nonmember banks and are subject to FDIC examination authority. To carry out its supervisory and examination responsibilities, the FDIC divided its examination force into 14 regional offices, with each office responsible for regularly examining insured state nonmember banks in its region. The agency has power to examine all the affairs of the bank.

The FDIC may examine any insured bank for insurance purposes, but to avoid duplicating the activity of other Federal bank supervisory agencies, it uses examination reports from the Comptroller of the Currency and the FRB to determine whether national and state member banks are worthy to continue as insured banks.[25]

Although the FDIC may accept the report of any agency supervising a state nonmember bank, thus far—except for some states with which it engages in joint examination—the agency has preferred to conduct its own examinations. At Commission hearings FDIC Chairman Frank Wille stated that "the objective of our examination and supervisory efforts with respect to state nonmember banks has always been to promote safe and sound banking conditions and practices in conformity with applicable law. To this end we regularly examine each such bank seeking to determine its financial condition."

Indeed, the FDIC has assumed many of the functions of a regulatory agency. The decision to accept or reject an application for deposit insurance for a new bank is analogous to the granting of a charter, for, in a modern insurance conscious society, a bank is unlikely to open without deposit insurance.[26]

The number of insured state nonmember banks examined by the FDIC is greater than the combined total of national and state member banks examined by the Comptroller and FRB.

On June 30, 1971, FDIC's examining function extended to 7,819 state nonmember banks as compared with 5,737 national and state member banks. Most state nonmember banks were "typically of small size" and comprised only "about 18 percent of all commercial bank deposits."[27]

The FDIC, like the Comptroller and the FRB, has the extraordinary power to issue cease and desist orders, and under the Financial Institutions Supervisory Act of 1966, is authorized to institute termination of insurance proceedings against an insured bank. If after hearing, an unsafe or unsound practice or violation has been established and not corrected within the specified time, the Corporation "may order the insurance terminated at a date subsequent." While the power to terminate insurance provides the FDIC with the mechanism to protect its insurance fund, it also puts the agency in the unique position of being able to induce insured banks to comply with all applicable laws, rules, and regulations.

Federal Home Loan Bank Board

Preston Martin, Chairman of the Federal Home Loan Bank Board (FHLBB), described that agency's major function as "exercising its regulatory authority over a major force for housing in our economy, the savings and loan industry, an industry with $181 billion in assets."[28]

The Federal Home Loan Bank System was created to provide credit reserves for savings and home-financing institutions. The FHLBB charters, examines, and supervises federal savings and loan associations under the provisions of Section 5 of the Home Owner's Loan Act of 1933. In addition, it directs the Federal Savings and Loan Insurance Corporation (FSLIC) as mandated by Title IV of the National Housing Act, to insure the safety of savings in thrift and home-financing institutions. In effect, the FHLBB does for savings and loan associations what the FRB, the FDIC, and the Comptroller of the Currency together do for commercial banks.[29]

The diverse examination functions of the FHLBB are performed by the Office of Examination and Supervision through 12 field districts. The purpose of examination is to prevent the default of federally chartered or state insured associations.

The majority of loans made under jurisdiction of the FHLBB are mortgage loans on residential property, amounting to approximately "$146.1 billion or more than 99 percent of all loans made by all insured institutions."[30] Of the remaining $1.2 billion, unsecured property improvement loans account for $667.4 million and unsecured educational loans for $170.6 million.

The extraordinary powers bestowed on Federal banking agencies to issue cease and desist orders and remove officers and directors for cause were also granted to the FHLBB with regard to insured Federal and state savings and loan associations. In addition the FHLBB may initiate suit to enforce the provisions of the Home Owners Loan Act, "rules and regulations made thereunder, or any other law or regulation."

National Credit Union Administration

In 1970 the National Credit Union Administration (NCUA)[31] was established as an independent agency in the executive branch of the Government. The NCUA replaced the Bureau of Federal Credit Unions of the Department of Health, Education, and Welfare as the agency responsible for supervising Federal credit unions.

On June 30, 1971, the NCUA had administrative and supervisory responsibilities over 12,956 Federal credit unions with appropriately $7 billion in consumer loans outstanding (including approximately $1 billion in real estate related loans).

The NCUA has the power to grant Federal charters to credit unions after determination of the character and fitness of the subscribers, and the economic advisability of establishing the proposed credit union. The Administrator of the NCUA is also empowered to conduct examinations and prescribe rules and regulations necessary for proper administration of such credit unions.

In addition, the Administrator is required to "insure the member accounts of all Federal Credit Unions" and may insure, on approval of application, the member accounts of state chartered credit unions. Each Federal credit union is required to apply for insurance of member accounts. If the insurance application of a Federal credit union is denied, "the Administrator shall suspend or revoke its charter unless, within one year after the rejection, the credit union meets the requirements for insurance and becomes an insured credit union."

The examination powers of the Administrator under the share insurance provisions are similar to those of the FDIC and other chartering entities. The Administrator has power to examine all affairs of the credit union to ensure that its financial condition and policies are not unsafe or unsound.

The NCUA, like other Federal financial regulatory agencies, has the authority to issue cease and desist orders if unsafe or unsound practices are found in examination of the business of the credit union or if the credit union "is violating or has violated or the Administrator has reasonable cause to believe that the credit union is about to violate a law, rule or regulation or any condition imposed in writing by the Administrator." In addition, the NCUA has power to terminate share insurance to protect its insurance fund.

As with other Federal financial regulatory agencies, primary focus of NCUA's examination is devoted to guaranteeing sound operation of the financial institutions under its jurisdiction.

State Agencies

There may be as many different ways in which state and territorial agencies and departments charged with enforcing consumer credit laws administer their primary supervisory and regulatory functions as the country has states and territories.

Banking Departments

The functions of state banking departments are best compared with those of the Comptroller of the Currency. Like the Comptroller, state banking departments have power to charter banks and examine them periodically. In conducting examinations, most departments have full access to all state bank records and power to subpoena necessary records or witnesses.

In many states, banking departments are not the highest authority on supervisory decisions. "Almost three-fifths of the states have banking boards, which in turn may have powers ranging from advisory to direct supervision decisions."[32] Many banking departments are not independent units of state government but divisions

of larger goverment units or individual agencies operating under the general direction of a state-level cabinet officer.

The ultimate purpose of bank examination at the state level is to protect the public interest and prevent bank failure. The focus of state examination, like examination by Federal agencies, is to ensure bank soundness.

Most state banking departments, however, have supervisory responsibilities far exceeding those entrusted to the Comptroller of the Currency and other Federal banking agencies. State banking department supervision extends to a varied range of nonbank financial institutions and activities. Often the scope of supervision includes state chartered credit unions, personal or consumer finance companies, and savings and loan institutions. In addition, banking department responsibilities may encompass supervision of safe deposit companies, industrial loan companies, mutual savings banks, pawnbrokers, money order companies and even the general credit granting community (see Exhibit 4-1).

Nonbanking Financial Institutions

Supervisory responsibility for nonbanking financial institutions may be placed in either:

1. a division within a state banking department;
2. an independent agency with total supervisory responsibility; or
3. a part of a statewide financial institutions department, with oversight responsibility for all financial institutions, banking and nonbanking.

Savings and Loan Associations and Credit Unions. State supervision of state savings and loan institutions and credit unions resembles that of the FHLBB and NCUA over federally chartered institutions.[33] The state has power to charter and examine the institutions periodically for soundness to protect the members' or depositors' interests.

Mutual Savings Banks. Supervision of mutual savings banks, in the few states in which they are located, is virtually identical to state banking department supervision of commercial banks, both in purpose and purview.

Consumer Finance Companies. In most states, the department responsible for supervising consumer finance companies operates under provisions of a state small loan law which is usually patterned after the Uniform Small Loan Law. Regulation of the consumer finance industry, unlike that of other financial institutions, is directly related to consumer credit protection.

Under the Uniform Small Loan Act, the supervisory agency performs a three-fold function.

First, it must determine whether an applicant qualifies for a license to make small loans.[34]

Second, after granting a license the supervisory agency is authorized to examine the books and records of licensees at least once a year for compliance with provisions of the law. This examination is intended to eliminate trickery, fraud, and oppressive collection practices which prevailed in the small loan market before the law was passed. If the agency finds the licensee violating, threatening to violate or intending to violate the law or its regulations, it may order the licensee to cease and desist and may seek court assistance to enjoin the activity.

Finally, the agency has the power to adopt rules and regulations necessary to provide the administrative machinery necessary for effective enforcement of the law.

The agencies that supervise personal finance companies often are also responsible for enforcing other legislation such as discount and industrial loans laws. Frequently these are hybrid laws intended to accomplish varied goals; often they serve to supplement small loan legislation by permitting larger loans than are allowed under the small loan law.[35] These additional laws, however, do not typically provide the consumer the type of regulatory protections afforded by most small loan acts.

Other Nonbanking Financial Institutions

In many states the agency charged with licensing responsibility for the small loan industry is also charged with licensing businesses engaged in purchasing instalment sales contracts from retail sellers. The scope of supervision over such institutions, however, is much narrower than that authorized by the small loan laws. In fact, "the supervising powers of state agencies under such provisions (licensing) are usually limited to administering the licensing requirements of the act, and are not expanded to include general responsibility for administering provisions of the entire retail instalment sales act"[36] or other consumer protection laws. Thus, the function of licensing businesses engaged in purchasing instalment sales contracts, in most states, is limited to making "a record of those engaged in such business activity. . .and to prevent unlicensed operations."[37]

Offices of the Attorneys General

At the state level attorneys general have wide-ranging responsibilities in protecting citizens. The attorney general, in effect, is the attorney for the state and its citizenry in civil, administrative, constitutional, and criminal matters (see Exhibit 4-2). Many are active in areas of environmental and consumer protection as well as in combating crime.[38]

The function of attorneys general in the area of consumer protection includes the prevention of all fraudulent, deceptive and unfair selling practices which may or may not involve extensions of consumer credit. Unlike the financial regulatory agencies, attorneys general have no general supervisory or examination powers. Instead, they must rely on complaints as the catalysts for their investigative and enforcement activities.[39]

Adequacy of Consumer Credit Protection

Specific agency responsibility in the area of consumer credit protection ranges widely. It can extend from examining for and enforcing compliance with the Truth in Lending Act—at the Federal level and in the five exempted states[40]—to enforcing a host of state laws which govern:

> entry into the credit granting field in the first place,. . .compliance with rate structures, . . .ensuring compliance with rebate, default and credit life insurance provisions, as well as guaranteeing that restrictions on remedies such as repossessions, deficiency judgment and holder in due course are complied with.[41]

The Commission first examined the consumer protection activities of the Federal financial supervisory agencies as they related to state consumer credit protection legislation. Then it examined state agency activities in the same area. Finally, the Commission reviewed the performance of the Federal agencies and four of the five exempted states in fulfilling their responsibilities under TIL. (At the time, Wyoming had not been granted an exemption by FRB.)

The Commission considered the role of all financial supervisory agencies involved with consumer credit protection. Its evaluation of agency performance was based on the following premises:

1. Consumer credit protection laws were intended to protect equally all the citizens of a state or of the United States.
2. The degree of this protection should not depend on whether the consumer deals with a Federal or a state chartered institution.
3. All agencies, state and Federal, responsible for examining state chartered institutions should conduct examinations designed to ensure compliance with applicable law, including state consumer credit protection legislation.
4. Any agency which lacks either the resources or inclination to perform its supervisory responsibilities adequately should improve its capability to the point where such duties can be adequately discharged or have its responsibilities assigned to another agency for effective performance.

The Commission believes that the Financial Institutions Supervisory Act of 1966 provides Federal agencies with the authority and power to require financial institutions under their jurisdiction to comply with all applicable laws, including existing state consumer credit protection laws.

In fact, the Financial Institutions Supervisory Act provides two alternative bases for enforcing consumer credit protection laws. Section 1464, 1786 and 1818 of Title 12 of the United States Code authorize the FHLBB, the Comptroller of the Currency, the FDIC and the FBR respectively, to issue cease and desist orders if a savings and loan or bank under their jurisdiction:

> is engaging . . . has engaged or the agency has reasonable cause to believe . . . is about to engage in an *unsafe* or *unsound practice, or* is violating . . . has violated or the agency has reasonable cause to believe . . . is about to violate a *law* . . . (emphasis added).

Since violations of state consumer credit protection laws may not necessarily threaten the *soundness* of the financial institution, even in light of potential class-action litigation, the argument has been made that the agencies are not authorized to act under this provision. However, the Commission notes that the Financial Institutions Supervisory Act of 1966 is drafted in the disjunctive and that *violations* of *law* are *per se* an adequate basis for agency action irrespective of the possible impact of the violations on institutional soundness.[42]

Bank Supervision

At both Federal and state levels, bank examinations focus on the soundness of bank activities.[43] This view is supported in a study of state bank supervision by Carter Golembe who stated "it is quite apparent that the large majority of state banking departments are acting very much as if they were insuring agencies."[44] By conducting examinations directed toward ensuring bank soundness, state examining forces are generally duplicating efforts of the FDIC and the FRB with regard to insured nonmember and state member banks, respectively. In terms of manpower 1,581 FDIC examiners and 520 FRB examiners check for soundness the same banks which are also examined for soundness by 1,541 state banking department examiners.[45] Thus it would appear that 1,541 state examiners are duplicating work performed by 2,101 Federal examiners (see Exhibits 4-4, 4-5, and 4-8). Overemphasis on soundness leaves other bank supervision functions, such as detection of fraudulent and irregular consumer credit practices, a poor second in the scale of priorities[46] and appears to be "an improper allocation of the limited resources available in the area of bank supervision generally."[47]

The extent of apparent duplication in the bank examination process is difficult to measure because "some states . . . . have either lacked the resources or inclination to do an adequate job of bank supervision."[48] Professor Benston's paper on bank examination maintained that states "as chartering agencies . . . are in much the same position as the Comptroller of the Currency, with one very important exception, their staffs and budgets are, in general, inadequate for the task of effective bank examination. The National Association of Supervisors of State Banks (now the Conference of State Bank Supervisors) in 1968 rated 35 states as inadequate in staff and 16 states inadequate in budget for bank supervision."[49] In such states it is clear that Federal bank supervisory agencies cannot be expected to accept state examination reports without independent Federal examination. Nonetheless, it is likely that the state agencies will direct whatever energy and funds they possess toward examining for soundness and ignore other matters such as detection of consumer credit protection law violations.

Federal supervisory agencies fail to supplement state activities in the areas of other supervisory responsibilities. At Commission hearings in 1971, FDIC's Chairman Wille stated that the FDIC "traditionally tended to limit our special concern to enforcement of state banking law, that is, those state laws peculiarly applicable to banks and designed in large measure to assure the safe and sound operation of those banks." He explained that these were "laws dealing . . . with required reserves and loan limits based on bank capital or on the value of property taken as security."

Governor J. L. Robertson, Vice Chairman of the Board of Governors of the Federal Reserve System, wrote the Commission that it has been the Board's "general policy, as part of our interest in joint federal-state efforts, to protect the liquidity and solvency of state banks subject to Federal Reserve supervision. But it seems clear that the *primary* responsibility for the enforcement of state laws with respect to institutions chartered by the state rightly lies with the state authorities, and that the informal assumption of that *primary* responsibility by the Federal Reserve authorities would not be in the National interest."[50]

First Deputy Comptroller of the Currency Watson testified before the Commission that the Office of the Comptroller "like most other federal agencies, is primarily concerned with enforcement of federal laws." Stating that the Comptroller's "statutory mandate or authority to enforce directly any state statute or regulation is limited," he acknowledged that Section 85 of Title 12 of the United States Code limits the permissible rate of interest charged by national banks to "the amount allowed by the laws of the State where the bank is located." However, this is a restriction on the conduct of national bank business imposed by the Federal—not state—lawmakers.

The Deputy Comptroller conceded that "contracts of national banks, like those of any other lender are subject in most respects to the law of the jurisdiction in which the contract is made." He recognized that many states have statutes providing special protection for consumer borrowers, but said that compliance with such provisions could be effectuated by competition between national banks and state lenders. He made no mention of the Comptroller's intent to examine for or enforce compliance with such laws.

These comments indicate that the Comptroller of the Currency, the FDIC, and the FRB view their responsibilities in bank supervision as virtually limited to protecting the solvency and liquidity of the nation's banking systems and not to protecting the public from violations of state laws which on their face seem unrelated to solvency. The Comptroller's failure to examine for and enforce such consumer protection laws is particularly serious because the Comptroller's office is the sole regulatory and supervisory authority for national banks. The FDIC and FRB defer to the Comptroller, and state agencies have no power to examine national banks. Such banks are not bound by state laws which "infringe on the national banking laws or impose an undue burden on the performance of the banks' functions;"[51] however, the Commission is convinced that state consumer credit protection laws do not fall into such a category. As far back as 1880, the Supreme Court found that the national banking laws did not evidence a Congressional intention to exempt national banks from the ordinary rules of law affecting the legality of actions founded on local matters.[52] If the Comptroller fails to examine for and enforce compliance of state consumer credit protection laws, national bank customers may be denied protections afforded customers of a state chartered bank next door, and citizens of the same state could unknowingly be covered by different standards of consumer credit protection. The Commission considers differing consumer credit protection standards to be inequitable.

While the Comptroller of the Currency, the FDIC, and the FRB appear to have adequate resources and determination to satisfy their primary responsibilities in guaranteeing a safe and sound banking system, the matter of consumer protection appears largely to be neglected at the Federal level. All three Federal banking agencies have instituted examination procedures designed to detect violations of the Truth in Lending Act—a Federal statute. But those violations are only the "tip of the iceberg" in the sea of consumer protection. Basic substantive consumer rights which are largely matters of state law appear to be of minimal concern to

Federal banking agencies, if, indeed, they are any concern at all.

Savings and Loan Associations

Just as with bank supervision, most emphasis and effort in examination of savings and loan associations are directed toward soundness. Here again Federal and state examiners duplicate each other's work, largely for the same reason that is responsible for duplication in bank supervision—the insurance of accounts or deposits thus giving both the chartering agency and the insuring agency an interest (only 211 out of 2,440 state chartered savings and loan associations are uninsured). In states where the FHLBB acts as the insuring agency, 2,250 state chartered savings and loans with 2,220 branches are examined for soundness by FHLBB and state examiners, to the extent that an adequate state examining force exists (see Exhibits 4-1, 4-6 and 4-8).

Testifying before the Commission, Chairman Preston Martin of the FHLBB stated, "even the federally chartered institutions, over which we have the most extensive control, are subject to state law in certain respects," but added that "compilance with state consumer protection laws is not an area of primary interest of our examiners" because of the minimal involvement of savings and loan institutions in consumer loans. The Commission understands that unsecured property improvements loans are only $667.4 million of a portfolio of $147.3 billion, but believes that violations of consumer laws could still affect substantial numbers of citizens. Although aware that savings and loan associations seek much broader powers in the field of consumer credit, the Commission has no evidence that broader powers would be accompanied by assurances that federally chartered associations would be examined for compliance with state consumer protection laws. The Commission questions how the FHLBB would ever know state consumer credit protection laws have been violated without efforts to ensure compliance. Violations of such laws might well have an adverse effect on the solvency of the institutions—a subject of paramount concern to the FHLBB. Additionally, if the FHLBB fails to examine federally chartered associations for compliance, no other agency has the power to make such examinations.

The FHLBB, through the Federal Savings and Loan Insurance Corporation, also insures the accounts of many state chartered savings and loan associations, just as the FDIC insures commercial banks' deposits. As insuror, the FHLBB has supervisory and examination authority over insured state associations to protect its insurance fund. Chairman Martin noted, however, that FHLBB was "not heavily involved with the enforcement of state consumer protection laws," and that "in most states . . . [the Board] conduct [s] . . . examinations of state chartered associations jointly with state supervisory authorities . . . [who] are primarily chargeable with matters of enforcement of state law."

The Commission agrees that enforcement of state consumer credit protection laws is primarily a state responsibility, but this does not preclude FHLBB examination for compliance with such laws, particularly in view of Chairman Martin's statement that "[w]hile . . . the states are primarily responsible for the enforcement of their own consumer protection laws, violation of state law by an insured institution, whether federally or state chartered, could be the basis for cease and desist action by our Board or, in an appropriate case, grounds for termination of insurance of accounts."

In view of the staffing, budgetary, and attitudinal limitations of many state supervisory agencies, supervision of savings and loan associations, like that of banks, probably is directed toward ensuring soundness and leaves other matters unattended.

Credit Unions

At Commission hearings in June, 1971, J. Deane Gannon, Deputy Administrator of the National Credit Union Administration stated that "we (the National Credit Union Administration) expect FCUs (Federal Credit Unions) to comply with state laws," but added that "[a]s NCUA does not have enforcement responsibilities for state consumer protection laws, it does not build into its examinations specific procedures for determining compliance." He said that NUCA's credit manual advises credit unions to obtain an attorney's opinion that special loan programs do not violate laws in the state where the Federal credit union does business. Asked why the NCUA conducts no compliance examinations, he said that the "vast majority of Federal credit unions are members of state leagues" and "the leagues see to it that member credit unions receive notice and information on changes in state law or regulation." He added that "[m]any times the league has its attorney review the law and determine its application to credit unions."

Mr. Gannon's testimony left several questions unanswered. If the NCUA does not examine for compliance with state law, how does it know whether Federal credit unions are complying with the law? It is one thing to expect Federal credit unions to comply with state law and another to examine to ensure compliance. In view of its exclusive examination and supervisory authority over Federal credit unions, who can examine for and enforce compliance if the NCUA does not? A supervisory agency like the NCUA should not rely on credit union or league attorneys to determine what laws are applicable to institutions under its

496-072 O - 73 - 6

jurisdiction, especially when an erroneous interpretation might affect the soundness of the institution and endanger depositors' funds. It may also result in the failure to extend protection of state laws to Federal credit unions customers.

Although the NCUA was authorized by the Federal Credit Union Act of 1970 to examine and supervise Federal and insured state chartered credit unions, NCUA's share insurance function has not yet been fully implemented.[53] For this reason, the Commission cannot now determine whether NCUA puts inordinate emphasis on examining for soundness. It is apparent, however, that some state examining agencies have neither sufficient staff nor budget to examine adequately the institutions under their supervision. Similarly, NCUA appears to be seriously understaffed in some states (Exhibit 4-7).

Consumer Finance Companies

Consumer finance companies are chartered only by states and have no Federal counterparts. State agencies charged with their supervision have complete responsibility for their examination and for determining whether the companies have complied with state consumer loan laws. The Commission sifted through the multiplicity of state laws and regulatory programs only to find that vast dissimilarities made comparisons among states almost impossible. The difficulty was heightened by the divergent enforcement attitudes of the regulatory agencies. Supervisory and enforcement activity ranged from vigorous to languid—not only from state to state but from agency to agency within states. This is partly explained by the frequently expressed view that public agencies which regulate private enterprises often begin to empathize with the industries they are supposed to supervise.[54]

The Commission computed the number of man-days per loan office each state consumer credit administrator had available per year to examine consumer finance companies.[55] For purposes of state comparisons, sampling techniques minimize differences in loan office sizes. Although it is impossible to demonstrate that any state has sufficient manpower to examine its consumer finance companies adequately, the Commission has no evidence that every state fails to provide sufficient resources for adequate examinations. The median figure for the 33 states[56] included in the calculations was 2.64 man-days available per office, with a range from 1.15 days to 6.14 days.[57] Virtually all administrators contacted by the Commission staff said that it took between 2 and 3 days to examine the average small loan office. Assuming the quality of a 2 to 3 day examination is sufficient to satisfy examination standards prescribed by statute, approximately half of the states comply with their mandates.

Administrators with less than 2.64 man-days available per office tended to focus examination activities on new licensees and licensees with a history of problems. While recognizing that variations exist in the size of states and the size of institutions examined, *the Commission recommends that legislatures and administrators in states with less than 2-1/2 man-days available per year per small loan office reassess their staffing capabilities with the goal of improving their ability to fulfill the examination responsibility prescribed by law.*

Unfortunately, many consumer credit protections presumed to exist at the state level are illusory. In many states where such legal protections exist, the consumer may not be truly protected in consumer credit transactions because the laws are not evenly enforced. Inconsistencies in administration and enforcement should not be allowed to continue. All consumer credit grantors should be subject to the same statutes and the same administrative controls, although not necessarily the same licensing, chartering, and examination procedures. Enforcement of statutes should be performed with consumer protection the primary concern—not creditor convenience.

Truth in Lending (TIL)

Federal Agencies

At the Federal level, the Commission found examination and enforcement to be a "mixed bag." Some agencies have no specific budget for TIL activities. Others have rather substantial budgets. Some agencies have found so many violations that it is difficult to understand how others have found so few. In some agencies all examiners apparently devote a certain percentage of their time to examining for TIL while in others only a specific portion of the examining staff devote time to TIL (see Exhibit 4-11). Two agencies assigned TIL responsibilities—the Interstate Commerce Commission and the Department of Agriculture—reported they had encountered no consumer credit problems under TIL. This is understandable, since few, if any, institutions subject to their jurisdiction extend consumer credit as defined by TIL. A third agency, the Civil Aeronautics Board, had virtually no enforcement activity.

Of the remaining six agencies charged with TIL enforcement, five—the Comptroller of the Currency, the FDIC, the FRB, the FHLBB, and the NCUA—exercise their authority to examine their respective supervised institutions on a regular basis. Each has adopted as a part of its examination process special procedures to test for TIL compliance. However, the vigor with which each

agency pursues these procedures varies widely. Some creditors are closely regulated and others are not. As with state consumer credit protection laws, the effectiveness of TIL protection varies with the Federal agency having regulatory authority. Such variations are intolerable. *The Commission recommends that all Federal regulatory agencies adopt and enforce uniform standards of Truth in Lending examination.*

The Federal Trade Commission (FTC) is unique as a TIL enforcement agency in that (1) it has no general and continuing supervisory and examination authority over creditors under its TIL jurisdiction, and (2) as a practical matter, it has no finite universe of creditors subject to its jurisdiction. The other eight Federal agencies have TIL enforcement authority over creditors which they regularly supervise, so that the exercise of that authority is (or should be) but one additional function applicable to a known roster of regulatees. The universe of creditors subject to FTC Truth in Lending jurisdiction far exceeds that of any other agency both in number and institutional diversity. Estimates of the number range as high as *one million* and include retailers who extend consumer credit, consumer finance companies, and state chartered credit unions. Excluded, of course, are state chartered and noncorporate creditors in the five states with TIL exemptions.

To fulfill its TIL responsibilities, the FTC established a Division of Consumer Credit (now a part of the Division of Special Projects) with a staff of 204 members, whose sole function is to administer the CCPA (including TIL). Because of the large number of creditors for which the FTC is responsible and obvious staff limitations, comprehensive examination for compliance was not possible. Instead the agency relied on a program of voluntary compliance and the deterrent effect of numerous complaint cases initiated by the Division staff.

In an attempt to effectuate compliance, however, the staff undertook examinations of disclosure statements of national and major regional creditors and initiated an extensive program of surveillance of advertising matter. The FTC also made a nationwide survey of creditor compliance to ascertain TIL trouble spots and focus on the types of creditors under their jurisdiction who need special surveillance. The Commission commends the FTC for efforts to fulfill a gargantuan assignment.

The Board of Governors of the Federal Reserve System is also to be commended for admirably drafting regulations and providing interpretations as prescribed under section 105 of the Truth in Lending Act.

State Agencies

If the Federal examination and enforcement of TIL is a "mixed bag," the state situation may be no better. The Commission recommends that all TIL exemptions be reviewed by the FRB in light of testimony before the Commission.

TIL regulatory functions currently exercised by the FRB, as well as TIL examination and enforcement functions which at present are assigned to nine different Federal agencies and five exempted states should be reassigned to the proposed Bureau of Consumer Credit. The Commission finds it unrealistic to impose on any agency a dichotomy of responsibility. If the agency's primary duty is to ensure the solvency and liquidity of institutions under its jurisdiction, it is unrealistic to expect that agency to enforce a law which provides for potentially substantial civil penalties for its violation. Agency assumption of an active consumer protection role could have a detrimental effect on the very solvency of an institution which the agency is required to protect.

THE PROBLEMS IN PERSPECTIVE

Problems in the field of enforcement of consumer credit laws range from familiar, old problems that have stubbornly resisted solution to emerging new areas of concern. Among the old problems found still to exist are these: (1) Federal agencies charged with supervising deposit-holding institutions have evidenced great interest in the solvency of the institutions, much less interest in enforcing Federal consumer credit laws, and virtually no interest in enforcing state consumer credit laws. Because state agencies are generally barred from examining federally chartered institutions, those institutions are not effectively examined for violations of state consumer credit laws. (2) State agencies charged with examining deposit-holding institutions are preoccupied largely with the solvency of the institutions even though their examinations often duplicate those of Federal authorities. This duplication of effort drains away resources that might otherwise be used for enforcement of consumer credit laws. (3) States have usually failed to set up effective mechanisms for across-the-board enforcement of consumer credit laws. Although state laws usually give administrators adequate powers to enforce credit laws against consumer finance companies, competing second mortgage lenders are generally subject to little or no administrative supervision. Similarly, in most states retailers are subject to no administrative supervision for credit law purposes. Recourse against retailers for violations of credit laws is usually limited to suit by aggrieved consumers or to criminal or injunctive procedures instituted by state attorneys general or local district attorneys. (4) State legislatures in the last two decades have enacted countless consumer protection statutes but have been reluctant to appropriate funds to enlarge consumer protection agencies in order to enforce

these laws. State agencies usually have adequate financing only when creditors pay for examinations, as with agencies examining deposit-holding institutions or consumer finance companies.[58]

Among the new problems are these: (1) Increased intervention by the Federal Government in the consumer protection area has raised difficult problems of Federal-state relations which call for reconsideration of the roles played by state and Federal authorities in enforcing consumer protection laws.

States not exempt from Federal TIL supervision may have two laws on disclosure of finance charges, the Federal TIL provisions and state laws which predate the Federal law and which have not been expressly repealed. Although TIL Section 111(a) purports to invalidate inconsistent state laws on disclosure, the FRB in regulation Z Section 226.6(c) allows creditors to continue to make disclosures pursuant to inconsistent state laws so long as they are separated from Federal disclosures and branded as being inconsistent with Federal law. Incredible as it may seem, if state law differs from the Federal law a creditor would apparently be required to disclose different APR's, one under Federal law and one under state law so long as the separation requirements of the regulation were observed.

In those nonexempted states there are two separate groups of enforcement officials—Federal agencies enforcing TIL and state agencies enforcing state consumer credit law—and, in most cases, both groups are enforcing different laws against the same creditors. Since only Federal authorities can enforce TIL, in nonexempt states the FTC has the burden of covering all state chartered credit unions, all retailers, consumer finance companies and second mortgage lenders with no help from state officials.

Nor is all well in the exempt states. Before exemptions are granted, state legislatures must enact a statute "substantially similar" to the Federal Truth in Lending Act (the FRB has interpreted this to mean "substantially identical") and rules must be adopted which incorporate the substantive provisions of regulation Z. Each time Congress amends TIL and each time the FRB amends regulation Z (which has happened a number of times), similar changes must be made in state statutes and rules; failure to make changes promptly may result in loss of the state's exemption. To obtain and maintain exemptions, states find themselves merely rubber-stamping Federal legislative and administrative provisions. Thus, the only effect of exemption is to permit state authorities exclusive enforcement powers with respect to TIL (except as to federally chartered institutions) and, of course, to deprive the FTC of such authority. After expending the effort necessary to obtain exemption from TIL, the money-starved states find that all they have achieved are greatly increased burdens (but probably not budgets) for their consumer protection agencies and the loss of FTC assistance. It is no wonder that exemptions have not been as eagerly sought as some thought they would be when TIL was enacted.

(2) Rising expectations of consumers concerning protection of their rights in credit transactions have focused attention on better ways of helping the consumer protect himself. No longer is it enough to have remote governmental authorities police creditors with the expectation that violations can be prevented or, once found, halted. Consumers want direct access to agencies capable of telling them of their rights and of assisting them in remedying wrongs done to them. They want educational programs to help them avoid trouble in consumer transactions. They want skilled legal services to press their claims. In short, aggrieved consumers yearn for a concerned and informed human being to hear their complaints and tell them what to do. The quality of enforcement of consumer credit laws must now be evaluated on the basis of availability to the public of educational programs, counseling facilities, and competent legal services, as well as by the old quantitative standards in terms of numbers of creditor examination agents.

Federal Watchdog Agency

The Commission's review of supervision and examination of credit grantors by state and Federal agencies charged with those responsibilities has uncovered certain weaknesses in the enforcement of state and Federal consumer credit protection laws. To strengthen protection of the consumer in the credit market the Commission feels that an organizational unit is needed at the Federal level to coordinate activities of supervisory agencies, improve compliance with existing Federal and state consumer credit protection laws, implement certain of the Commission's recommendations and continue certain of the basic consumer credit market research initiated by the Commission. Therefore *the Commission recommends that Congress create within the proposed Consumer Protection Agency a unit to be known as the Bureau of Consumer Credit (BCC) with full statutory authority to issue rules and regulations and supervise all examination and enforcement functions under the Consumer Credit Protection Act, including TIL.* The BCC would also encourage state consumer credit administrators and banking departments to augment existing staff, where necessary, and improve existing examination and enforcement procedures. For these purposes, the BCC should be empowered to make independent determination of the adequacy of state supervision, examination,

and enforcement of applicable state and Federal consumer credit protection laws and recommend to Congress steps the BCC deems necessary to ensure protection of the consuming public in credit transactions.

If Congress should not enact the proposed Consumer Protection Agency, the Commission recommends—as an alternative to the BCC—creation of an independent Consumer Credit Agency to implement some Commission recommendations.

The following specific recommendations relate to creation of the Bureau:

The BCC should monitor progress in the development of competitive consumer credit markets (Chapter 7) as well as in the elimination of discriminatory practices in granting consumer credit (Chapter 8). It should also undertake research to develop viable credit scoring systems to facilitate credit granting in poverty areas (Chapters 8 and 9).

The BCC should be empowered to cooperate with and offer technical assistance to states in matters relating to consumer credit protection—examinations, enforcement, and supervision of consumer credit protection laws.

To fulfill the BCC's responsibilities as a CCPA rulemaking body and to permit it to evaluate and monitor state activities in areas of consumer credit protection and in development of competitive consumer credit markets, the BCC should be authorized:

(1) to require state and Federal agencies that supervise institutions which grant consumer credit to submit such written reports;
(2) to administer oaths;
(3) to require by subpoena the attendance and testimony of witnesses and the production of all documentary evidence relevant to the execution of its duties;
(4) to intervene in corporate mergers and acquisitions which might lessen competition in consumer credit markets. The authority to intervene should include but not be limited to applications for new charters, offices, branches, etc.;
(5) in the case of disobedience to a subpoena or order issued, to invoke the aid of any district court of the United States in requiring compliance with such subpoena or order; and,
(6) in any proceeding or investigation, to order testimony to be taken by deposition before any person designated by the Bureau who has the power to administer oaths, and in such instances to compel testimony and the production of evidence in the same manner as authorized under subparagraphs (3) and (5) above.

If barriers to competition in the consumer credit market are not eliminated, federally chartered finance companies should be established utilizing the BCC as the chartering and supervisory agency (Chapter 9).

The Commission believes the activities of the BCC will help to create an environment of consumer credit protection heretofore unattained.

SUMMARY

Of the broad recommendations which can be made on enforcement of consumer credit protection laws, some are intended to advance healthy trends which have been developing while a few call for departure from existing procedures.

Deposit Holding Institutions

Agencies regulating deposit-holding institutions have long been devoted to the traditional role of examining to prevent institutional failure. It is no surprise, then, that these agencies have not eagerly enforced consumer credit protection laws against the institutions they regulate. Vigorous enforcement of such laws would not be welcomed by agencies with limited personnel resources and heavy responsibility for maintaining the safety of depositor funds. Perhaps more important are attitudinal obstacles. These agencies are accustomed to insuring institutional soundness and protecting depositors, and the assumption of responsibility for enforcing laws protecting debtors would require a significant change in attitude. However, the growing threat of class action suits by aggrieved debtors and the potential for large amounts in damages should alert institutions and supervisory agencies to the benefits of preventive examination for compliance with consumer credit protection laws.

Two persistent criticisms about regulation of deposit-holding institutions are: first, federally chartered institutions not only have failed to enforce consumer protection laws but have refused visitation rights to state authorities to allow for enforcement. Second, limited resources of state examination agencies are wasted on bank examinations which largely duplicate the work of Federal examiners, particularly in the case of FRB state member banks and nonmember banks insured by the FDIC.

The Commission recommends that agencies supervising federally chartered institutions undertake systematic enforcement of Federal credit protection laws like Truth in Lending.

Checking for violations can be a routine part of every examination without unduly burdening examiners. Testimony from a Commission hearing indicates that agencies are moving in that direction. The trend should be encouraged. National banks hold billions of dollars

worth of notes and assigned contracts that may not be adequately examined by Federal authorities and cannot be examined by authorities of the states whose laws govern these contracts. *The Commission recommends that Federal law be expressly changed to authorize state officials to examine federally chartered institutions for the limited purpose of enforcing state consumer laws, but such authorization should in no way empower state officials to examine federally chartered institutions for soundness, fraudulent practices, or the like. The limited state examination should be required by law to be performed in a manner that would not disrupt or harass the federally chartered institutions.* State examiners could accompany Federal examiners as additional members of the examination team. Institutions could compensate the state for its examiners' services at rates equal to those paid for Federal examiners.

Although the banking industry favors elimination of dual examination by Federal and state agencies, all but a few state banks undergo dual examination for soundness, fraud, and management evaluation. The Commission believes that this is a wasteful duplication and that to the extent possible state and federal agencies should work together to assure that examination for soundness be primarily a Federal responsibility. This would be desirable from a consumer standpoint because it would leave more resources available to state authorities to devote to enforcing state and Federal consumer credit laws in state banks.[59]

Nondeposit Holding Lenders

Two developments are needed for nondeposit holding lenders to provide adequate consumer protection.

(1) Licensed lenders are usually well supervised by state agencies for compliance with state consumer laws, but other consumer lenders are not. *The Commission recommends that state consumer credit laws be amended to bring second mortgage lenders and any other consumer lenders under the same degree of administrative control imposed on licensed lenders.* This can be done by (a) defining a consumer loan as one with an APR high enough to exclude residential purchase money first mortgage credit—say 12 percent—made for personal, family, or household purposes; (b) requiring all credit related charges such as brokerage fees, points, and commissions to be included in the finance charge; and (c) requiring any creditor to obtain a license before making a consumer loan.

(2) A basic change in Federal-state relations with respect to Federal consumer credit laws must be made. The Federal Government may well become a more important source of legislation applicable to consumer transactions. Congress presented states with two somewhat unsatisfactory alternatives in TIL enforcement: A state may obtain an exemption and then enforce TIL against all creditors (except federally chartered institutions) with no Federal financial assistance, or it may leave enforcement to the FTC and other Federal enforcement agencies. Most states have chosen the latter. If the Federal Government and the states are to coexist in consumer credit legislation and enforcement activities, an effective working relationship must replace the all-or-nothing exemption option.

The Commission recommends that Congress consider whether to empower state officials to enforce Truth in Lending and garnishment restrictions of the Consumer Credit Protection Act and any similar laws that may be enacted. Concurrent jurisdiction over TIL is expressly given to state courts. Why not concurrent enforcement powers for state officials? The benefits are obvious in the licensed lender field whose operations are examined in minute detail in many states. The skilled state examiner could also look for TIL violations and ease the already heavy FTC workload. The FTC has agreements with some state agencies which provide for state examination and reporting of TIL violations to the FTC. Federal legislation might go further and allow a state agency to treat a TIL violation as a violation of state law subject to remedies (cease and desist powers, etc.) available under state law. Duplication of efforts by Federal and state authorities could be eliminated and expenses of enforcement shared.

Retailers and Their Assignees

The Commission recommends that state laws covering retailers and their assignees be amended, where necessary, to give authority to a state administrative agency to enforce consumer credit laws against all sellers who extend consumer credit. However, administrative regulation need not and should not entail either licensing or limitations on market access.

Only a few states exercise this authority over sellers, but buyers are as entitled to protection and enforcement as borrowers.

Regulation of retailers must, of course, be extended to assignees of consumer credit paper. All banks and, in many states, sales finance companies are subject to administrative control. *The Commission recommends that states which do not subject sales finance companies to enforcement of consumer credit laws amend their laws to bring such companies under enforcement. Such authority need not and should not entail licensing or limitations on market access.*

The degree of administrative control must be determined by the availability of resources. The sheer number of retail outlets would appear to make detailed periodic examination and voluminous reports similar to those

required of deposit-holding institutions and consumer finance companies unrealistic. The almost unanimous conclusion of state administrators testifying before the Commission was that reliance on consumer complaints is an inadequate basis for consumer protection. To some degree administrators must take the initiative and seek out violations by examining retail creditors.

New developments in retail credit operations should make enforcement easier. Many retailers now participate in credit card plans in which the issuer extends and holds the credit and the retailers either reduce or abandon their own credit plans. Administrative control over a few credit card issuers may accomplish what previously would have taken an army of examiners to do. Also, use of centralized electronic data processing by retail creditors with multiple branches eases the examiners' tasks.

Many large item credit sales—automobiles, furniture, and appliances—are still made by closed end instalment contracts assigned to banks or sales finance companies. Laws which abolish the holder in due course doctrine and subject assignees to liability for knowingly violating credit laws are powerful factors in enlisting natural market forces to enforce credit laws (see Chapter 10). Assignees generally will not buy trouble, avoiding those dealers known to write contracts which violate laws.

TIL enforcement is most needed in the retail field where reprehensible credit sellers prey on the poor and ignorant. Administrative agencies need all the weapons they can muster against these abusers and often a TIL violation is the easiest charge to prove.

Better Enforcement at All Levels

Consumer credit laws come from the Congress, state legislatures, and local governments. Each has enforcement units that should help make the laws effective. At the Federal level the FTC is adding valuable experience to its commendable enthusiasm in enforcing Federal consumer protection laws. Because the FTC is free of any continuing relationship with any class of credit supplier, it possesses singular objectivity. Congressional commitment to consumer protection may well be gauged by the degree to which FTC appropriations match the additional workload caused by new consumer protection laws. Federal agencies which charter or insure financial institutions may lack the verve of independent agencies in enforcing credit laws, but they can observe operations of institutions under their supervision and can perform a valuable service by examining for credit violations.

Consumers are entitled to much better consumer credit protection law enforcement at the state level than they have been receiving. Inconsistencies that have left some lenders heavily regulated, others virtually unregulated, and sellers regulated in only few states can no longer be tolerated. *The Commission recommends that state laws be amended to give a state administrative agency authority to enforce consumer credit laws against all credit grantors—deposit holding institutions, non-deposit holding lenders, and retailers and their assignees. This authority should include the right to enter places of business, to examine books and records, to subpoena witnesses and records, to issue cease and desist orders to halt violations, and to enjoin unconscionable conduct in making or enforcing unconscionable contracts. The agency should be able to enforce the rights of consumers, as individuals or groups, to refunds or credits owing to them under appropriate statutes.* Across-the-board administrative control over all creditors is essential for an adequate level of state enforcement. Most states now have separate administrative agencies, usually the chartering or licensing agency, charged with supervising banks, savings and loan associations, and consumer finance companies. Another agency to oversee non-licensed creditors such as retailers must be created unless such enforcement is assigned to an existing agency.

The proliferation of agencies at the state level seems to be wasteful of limited enforcement resources. Placing authority to enforce all consumer laws against all credit suppliers under a single administrator and establishing separate subdepartments to license and supervise different types of creditors seems an ideal structure. If political or other considerations make such centralization infeasible, a consumer protection board composed of heads of consumer-related agencies should be established which should meet regularly to coordinate enforcement activities.

It is at the local level that some of the most innovative and useful enforcement activity occurs, possibly because local agencies supervise no financial institutions. The New York City Bureau of Consumer Affairs has been as creative in finding new ways to protect consumers as it has been tenacious in enforcing laws. Other cities, Los Angeles among them, are patterning programs on the New York experience. Federal and state agencies have failed to develop communication interchange necessary for a truly effective consumer protection program. It may be that communication between consumers and governmental regulators can be most effective at the local level. The local representative can more effectively halt the put-offs and run arounds, obtain quicker action, and provide on the spot advice. The local ombudsman can use persuasion and publicity as primary tools, but the legal authority needed cannot be assessed until the office is funded, staffed, and operating.

Legal Services

Consumer credit transactions normally involve such comparatively small sums that it is often difficult to interest lawyers in litigation involving them. However, litigation brought by aggrieved private consumers may prove a powerful deterrent to institutional misconduct. Low income consumers have found advocates of their rights in legal services programs. Therefore, *the Commission recommends that legal services programs—legal aid, neighborhood legal services, rural legal assistance, public defender—continue to receive Federal, state, and local government support.*

Litigation by the private consumer would be encouraged if statutes assure payment of fees to the consumer's lawyer in cases in which he prevails. Such fees should be based on the reasonable value of the service, not on the amount of recovery. *The Commission recommends that consumer protection laws be amended, where necessary, to assure payment of legal fees incurred by aggrieved private consumers and provide them with remedies they can enforce against creditors who violate these laws.*

Watchdog Agency

The Commission recommended a Bureau of Consumer Credit in the Consumer Protection Agency if established by Congress. Failing that, the Commission recommended creation of a Consumer Credit Agency to implement some of its recommendations.

EXHIBIT 4-1

STATUS OF STATE BANK SUPERVISION

Major Regulatory Responsibilities in Addition to Commercial Banks[1]

State	Mutual Savings Banks	Credit Unions	Savings and Loan Associations	Industrial Loan Companies	Money Order Companies	Finance Companies
Alabama		x	x			x
Alaska	x					x
Arizona		x	x			x
Arkansas				x		x
California						
Colorado		x		x	x	x
Connecticut	x	x	x			x
Delaware	x		x		x	x
Florida			x	x		
Georgia		x			x	
Hawaii			x	x		
Idaho		x	x			x
Illinois						
Indiana	x			x		
Iowa		x				x
Kansas						
Kentucky		x	x	x		x
Louisiana		x	x		x	x
Maine	x	x	x	x		x
Maryland	x	x		x	x	
Massachusetts	x	x	x		x	x
Michigan		x	x			x
Minnesota	x	x	x	x		x
Mississippi		x		x	x	x
Missouri		x				x
Montana		x	x			x
Nebraska		x	x	x	x	x
Nevada						x
New Hampshire	x	x				x
New Jersey	x	x	x		x	x
New Mexico		x	x		x	x
New York	x	x	x	x	x	x
North Carolina					x	x
North Dakota		x	x			x
Ohio						

EXHIBIT 4-1 (Cont'd)

STATUS OF STATE BANK SUPERVISION

Major Regulatory Responsibilities in Addition to Commercial Banks(1)

State	Mutual Savings Banks	Credit Unions	Savings and Loan Associations	Industrial Loan Companies	Money Order Companies	Finance Companies
Oklahoma		x	x		x	
Oregon	x	x		x	x	x
Pennsylvania......	x	x	x		x	x
Puerto Rico	x				x	x
Rhode Island	x	x	x			x
South Carolina....		x	x			
South Dakota.....			x			x
Tennessee........		x				
Texas					x	
Utah............		x	x	x		x
Vermont.........		x	x			x
Virginia		x	x	x		x
Washington	x			x		x
West Virginia		x	x	x		x
Wisconsin........	x	x				x
Wyoming			x			x
TOTALS	16	33	28	17	17	37

(1) The types of non-bank financial institutions under the jurisdiction of the state banking department vary considerably from state to state; in addition to the responsibilities listed here, some departments supervise such activities as investment companies, insurance firms, employee welfare funds, money remitters, development corporations, mortgage companies and perpetual care cemeteries.

Source: 1971 Survey of State Bank Supervisors

EXHIBIT 4-2

Staffing of State Attorneys General's Consumer Protection Agencies (as of February 1971)

State	Attorneys	Investigators	Clerical	Student Aides
Alabama	1 PT			
Alaska	0	0	0	0
Arizona	1 FT	1 FT	1 PT	
Arkansas	2 PT			
California	6 FT, 4 PT	4 FT	4 FT, 4 PT	
Colorado	1 FT	1 FT	1 FT	1 FT
Georgia	1 PT			
Hawaii	3 FT	5 FT	4 FT	2 FT
Illinois	14 FT, 3 PT	7 FT	14 FT	
Indiana	1 PT			
Iowa	2 FT	2 PT	2 FT	1 PT
Kansas	1 PT	1 FT, 3 PT	1 PT	
Kentucky	1 FT		1 FT	1 FT
Maine	1 PT	2 PT		
Maryland	2 FT	3 FT, 1 PT	3 FT	8 FT
Massachusetts	4 FT	9 FT	4 FT	5 FT
Michigan	2 FT	1 FT	3 FT	
Minnesota	1 FT	1 PT		
Missouri	1 FT, 1 PT	2 FT, 1 PT	3 FT, 1 PT	1 PT
Nebraska	1 PT			
New Jersey	2 FT	15 FT	13 FT	3 PT
New Mexico	2 PT	2 PT	1 PT	
New York	12 FT	3 FT	4 FT	
North Carolina	6 FT	4 FT	10 FT	
North Dakota	1 PT			
Ohio	1 FT	5 FT		2 FT
Oklahoma	2 PT			
Oregon	1 PT			
Pennsylvania	3 FT	11 FT	6 FT	
Puerto Rico	7 FT	75 FT	68 FT	(116–Other)
South Dakota	1 PT	1 PT		
Texas	5 FT	1 FT		
Virgin Islands	8 PT			
Washington	6 FT, 2 PT	5 FT, 1 PT	3 FT, 9 PT	
West Virginia	1 PT	1 PT		
Wisconsin	1 FT, 1 PT	1 FT	3 FT	4 FT

FT: Full Time
PT: Part Time

Source: Report on The Office of the Attorney General, National Association of Attorneys General, Committee on the Office of the Attorney General, February 1971.

EXHIBIT 4-3

Examination Staff of the Office of the Comptroller of the Currency (as of January 1972)

Region	State	Banks	Branches	Examiners
1	Connecticut	26	249	8
	Maine	19	109	6
	Massachusetts	82	441	49
	New Hampshire	48	54	10
	Rhode Island	5	95	9
	Vermont	26	49	4
2	New Jersey	120	753	113
	New York	167	1,338	116
3	Delaware	5	4	0
	Pennsylvania	286	1,088	107
4	Indiana	122	362	24
	Kentucky	80	151	12
	Ohio	218	776	54
5	District of Columbia	14	106	19
	Maryland	39	270	6
	North Carolina	23	615	8
	Virginia	101	511	41
	West Virginia	87	0	14
6	Florida	230	0	56
	Georgia	62	216	17
	South Carolina	19	230	10
7	Illinois	415	71	95
	Michigan	104	581	25
8	Alabama	88	209	28
	Arkansas	69	88	11
	Louisiana	49	185	15
	Mississippi	38	145	9
	Tennessee	77	290	33
9	Minnesota	198	7	60
	North Dakota	42	10	9
	South Dakota	32	63	11
	Wisconsin	126	68	24
10	Iowa	100	60	18
	Kansas	171	35	16
	Missouri	98	26	36
	Nebraska	125	26	18

EXHIBIT 4-3 (Cont'd)

Examination Staff of the Office of the Comptroller of the Currency (as of January 1972)

Region	State	Banks	Branches	Examiners
11	Oklahoma	195	32	32
	Texas	532	0	125
12	Arizona	3	226	7
	Colorado	121	13	38
	New Mexico	33	79	9
	Utah	8	75	9
	Wyoming	42	0	8
13	Alaska	5	52	0
	Idaho	7	114	6
	Montana	52	1	12
	Oregon	8	257	18
	Washington	24	463	27
14	California	57	2,473	118
	Hawaii	1	9	0
	Nevada	4	64	2
	Totals	4,603	13,139	1,502

Source: Office of the Comptroller of the Currency.

EXHIBIT 4-4

Examination Staff of the Federal Deposit Insurance Corporation (as of June 30, 1971)

Region and State	Number of Banks	Number of Branches	Number of Examiners
Atlanta	821	240	129
Alabama			
Florida			
Georgia			
Boston	300	839	98
Connecticut			
Maine			
Massachusetts			
New Hampshire			
Rhode Island			
Vermont			
Chicago	865	295	157
Illinois			
Indiana			
Columbus	499	373	91
Kentucky			
Ohio			
West Virginia			
Dallas	980	137	115
Colorado			
New Mexico			
Oklahoma			
Texas			
Madison	569	422	90
Michigan			
Wisconsin			
Memphis	698	670	114
Arkansas			
Louisiana			
Mississippi			
Tennessee			
Minneapolis	795	102	94
Minnesota			
Montana			
North Dakota			
South Dakota			
Wyoming			
New York	255	900	174
New Jersey			
New York			
Puerto Rico			
Virgin Islands			

EXHIBIT 4-4 (Cont'd)

Examination Staff of the Federal Deposit Insurance Corporation (as of June 30, 1971)

Region and State	Number of Banks	Number of Branches	Number of Examiners
Omaha	814	256	103
Iowa			
Nebraska			
Philadelphia	160	646	93
Delaware			
Pennsylvania.			
Richmond	313	1,271	94
Dist. of Col.			
Maryland			
North Carolina			
South Carolina			
Virginia			
St. Louis.	902	89	110
Kansas			
Missouri			
San Francisco	256	922	119
Alaska			
Arizona			
California			
Guam			
Hawaii			
Idaho			
Nevada			
Oregon			
Utah			
Washington			
Totals	8,227	7,162	1,581

Source: Federal Deposit Insurance Corporation.

EXHIBIT 4-5

Examination Staff of the Federal Reserve System
(as of June 30, 1971)

District and State	Number of Banks	Number of Branches	Number of Examiners
Boston	25	333	43
Connecticut			
Maine			
Massachusetts			
New Hampshire			
New York	97	1,180	118
Connecticut			
New Jersey			
New York			
Philadelphia	25	243	34
Delaware			
New Jersey			
Pennsylvania			
Cleveland	138	485	38
Kentucky			
Ohio			
Pennsylvania			
West Virginia			
Richmond	91	235	42
Dist. of Col.			
Maryland			
North Carolina			
South Carolina			
Virginia			
West Virginia			
Atlanta	63	130	36
Alabama			
Florida			
Georgia			
Louisiana			
Mississippi			
Tennessee			
Chicago	285	499	66
Illinois			
Indiana			
Iowa			
Michigan			
Wisconsin			

EXHIBIT 4-5 (Cont'd)

Examination Staff of the Federal Reserve System
(as of June 30, 1971)

District and State	Number of Banks	Number of Branches	Number of Examiners
St. Louis	110	90	32
Arkansas			
Illinois			
Indiana			
Kentucky			
Mississippi			
Missouri			
Tennessee			
Minneapolis	110	47	19
Michigan			
Minnesota			
Montana			
North Dakota			
South Dakota			
Wisconsin			
Kansas City	102	17	19
Colorado			
Kansas			
Missouri			
Nebraska			
New Mexico			
Oklahoma			
Wyoming			
Dallas	62	41	24
Arizona			
Louisiana			
New Mexico			
Oklahoma			
Texas			
San Francisco	30	412	49
California			
Idaho			
Nevada			
Utah			
Washington			
Totals	1,138	3,712	520

Source: Federal Reserve System

496-072 O - 73 - 7

EXHIBIT 4-6

Examination Staff of the Federal Home Loan Bank Board (as of January 1972)

FHLBB District and State	Federally Chartered Institutions	Federally Chartered Branches	State Insured Institutions	State Insured Branches	Number of Examiners Per District
No. 1 - Boston	69	86	80	27	21
Connecticut	18	43	17	10	
Maine	9	5	15	2	
Massachusetts	31	34	26	1	
New Hampshire	7	0	12	0	
Rhode Island	2	3	5	14	
Vermont	2	1	5	0	
No. 2 - New York	119	223	276	275	52
New Jersey	24	43	184	200	
New York	86	158	92	75	
Puerto Rico	9	20	0	0	
Virgin Islands	0	2	0	0	
No. 3 - Pittsburgh	149	144	188	126	46
Delaware	2	1	2	1	
Pennsylvania	124	143	179	125	
West Virginia	23	0	7	0	
No. 4 - Greensboro	466	575	232	229	75
Alabama	52	44	7	13	
Dist. of Col.	11	22	9	19	
Florida	128	204	5	2	
Georgia	98	98	4	0	
Maryland	59	62	22	32	
North Carolina	39	47	129	80	
South Carolina	47	39	23	22	
Virginia	32	59	33	61	
No. 5 - Cincinnati	298	257	205	200	63
Kentucky	91	33	12	2	
Ohio	137	179	193	198	
Tennessee	70	45	0	0	
No. 6 - Indianapolis	139	205	93	94	29
Indiana	103	67	66	15	
Michigan	36	138	27	79	
No. 7 - Chicago	189	23	396	48	63
Illinois	149	2	310	0	
Wisconsin	40	21	86	48	
No. 8 - Des Moines	157	134	136	98	28
Iowa	45	17	36	14	
Minnesota	52	61	11	2	
Missouri	44	51	78	69	
North Dakota	7	5	4	13	
South Dakota	9	0	7	0	

EXHIBIT 4-6 (Cont'd)

Examination Staff of the Federal Home Loan Bank Board (as of January 1972)

FHLBB District and State	Federally Chartered Institutions	Federally Chartered Branches	State Insured Institutions	State Insured Branches	Number of Examiners Per District
No. 9 - Little Rock	200	80	309	285	63
Arkansas	40	12	22	6	
Louisiana	36	10	68	44	
Mississippi	35	12	5	3	
New Mexico	10	8	21	11	
Texas	79	38	193	221	
No. 10 - Topeka	102	76	130	141	31
Colorado	20	24	31	72	
Kansas	29	15	59	44	
Nebraska	23	13	18	16	
Oklahoma	30	24	22	9	
No. 11 - Los Angeles	72	267	147	538	86
Arizona	3	26	10	45	
California	68	238	132	476	
Nevada	1	3	5	17	
No. 12 - Seattle	89	159	62	159	33
Alaska	3	5	0	0	
Hawaii	2	5	8	52	
Idaho	8	12	3	7	
Montana	11	7	1	0	
Oregon	18	41	12	47	
Utah	6	6	7	12	
Washington	32	82	27	37	
Wyoming	9	1	3	3	
Guam	0	0	1	1	
Totals	2,049	2,229	2,256	2,220	590

Source: Federal Home Loan Bank Board.

EXHIBIT 4-7

Examination Staff of the National Credit Union Administration (as of December 1971)

State	Credit Unions	Examiners
Alabama	236	5
Alaska	38	1
Arizona	118	3
Arkansas	92	1
California	1,238	38
Colorado	172	4
Connecticut	307	11
Delaware	82	2
District of Columbia	187	11
Florida	339	7
Georgia	276	6
Hawaii	169	5
Idaho	66	1
Illinois	419	13
Indiana	487	6
Iowa	14	
Kansas	73	1
Kentucky	125	2
Louisiana	373	9
Maine	164	5
Maryland	204	2
Massachusetts	360	9
Michigan	394	10
Minnesota	65	1
Mississippi	155	3
Missouri	44	1
Montana	122	2
Nebraska	96	2
Nevada	66	1
New Hampshire	33	1
New Jersey	540	12
New Mexico	67	1
New York	1,082	26
North Carolina	111	1
North Dakota	33	1
Ohio	719	19
Oklahoma	138	3
Oregon	230	6
Pennsylvania	1,304	33
Rhode Island	31	1
South Carolina	137	3
South Dakota	114	2
Tennessee	209	9
Texas	938	22
Utah	98	3
Vermont	3	

EXHIBIT 4-7 (Cont'd)

Examination Staff of the National Credit Union Administration (as of December 1971)

State	Credit Unions	Examiners
Virginia	248	4
Washington	210	5
West Virginia	169	3
Wisconsin	6	
Wyoming	55	
Totals	12,956	317

Source: National Credit Union Administration

EXHIBIT 4-8

Examination Staffs of State Banking Departments (as of June 1971)

State	Banks and Trust Companies	Branches	Total Banks and Branches	Number of Examiners
Alabama	184	81	265	
Alaska	6	7	13	1*
Arizona	10	113	123	14*
Arkansas	184	84	268	15+
California	93	651	744	54
Colorado	154	7	161	18
Connecticut	34	209	243	41°
Delaware	13	89	102	3*
District of Columbia	3	36	39	
Florida	300	28	328	42°
Georgia	374	154	528	38
Hawaii	9	132	141	18*
Idaho	17	48	65	
Illinois	709	42	751	98
Indiana	285	299	584	26
Iowa	567	265	832	44
Kansas	430	35	465	23
Kentucky	263	194	457	22
Louisiana	183	220	403	19
Maine	24	126	150	14 y
Maryland	73	378	451	21
Massachusetts	75	331	406	57
Michigan	229	656	885	48
Minnesota	533	7	540	42
Mississippi	145	212	357	15
Missouri	575	70	645	62
Montana	93	5	98	10y
Nebraska	315	18	333	22
Nevada	4	26	30	5
New Hampshire	26	12	38	16y
New Jersey	90	345	435	45z
New Mexico	34	59	93	14
New York	145	1,090	1,235	317*
North Carolina	73	591	664	16
North Dakota	127	59	186	
Ohio	297	577	874	42
Oklahoma	237	22	259	19
Oregon	38	95	133	10
Pennsylvania	167	695	862	69
Rhode Island	8	80	88	
South Carolina	81	188	269	12
South Dakota	128	40	168	8
Tennessee	232	222	454	25
Texas	678	62	740	85
Utah	40	64	104	3
Vermont	17	38	55	6*
Virginia	136	350	486	

See footnotes at end of table.

EXHIBIT 4-8 (Cont'd)

Examination Staffs of State Banking Departments (as of June 1971)

State	Banks and Trust Companies	Branches	Total Banks and Branches	Number of Examiners
Washington	64	121	185	16
West Virginia	115	6	121	12*
Wisconsin	483	212	695	48
Wyoming	29	1	30	6
Totals				1,541

* Responsible for examining all financial institutions.

+ Responsible for examining all financial institutions except credit unions and savings and loans.

o Responsible for examining savings and loans as well.

y Responsible for examining all financial institutions except consumer finance and related institutions.

z Responsible for examining commercial and savings banks.

Source: Conference of State Bank Supervisors

EXHIBIT 4-9

STATE CHARTERED INSTITUTIONS
Consumer Finance Companies with Designated Examiners
(as of November 1971)

State	Number of Offices	Number of Examiners	Man-Days Available	Man-Days Available Per Office
Alabama	396	5	1,200	3.03
Alaska				
Arizona				
Arkansas				
California	1,995	51	12,240	6.14
Colorado	750	4	960	1.28
Connecticut	417	10	2,400	5.75
Delaware				
Dist. of Col.				
Florida	914	10	2,400	2.63
Georgia	1,112	12	2,880	2.59
Hawaii				
Idaho				
Illinois	800	12	2,880	3.6
Indiana	781	16	3,840	4.92
Iowa	354	4	960	2.71
Kansas	329	7	1,680	5.11
Kentucky	451	5	1,200	3.66
Louisiana	941	5	1,200	1.28
Maine				
Maryland	340	6	1,440	4.24
Massachusetts				
Michigan	600	8	1,920	3.20
Minnesota				
Mississippi	425	8	1,920	4.52
Missouri	580	3	720	1.24
Montana	65	1	240	3.70
Nebraska	208	1	240	1.15
Nevada				
New Hampshire	88	1	240	2.73
New Jersey	499	5	1,200	2.40
New Mexico	201	1	240	1.19
New York				
North Carolina	566	5	1,200	2.12
North Dakota				
Ohio	1,556	11	2,640	1.70
Oklahoma	508	4	960	1.89
Oregon	233	2	480	2.06
Pennsylvania				
Rhode Island				
South Carolina	682	6	1,440	2.11
South Dakota	72	1	240	3.33
Tennessee	455	5	1,200	2.64

EXHIBIT 4-9 (Cont'd)

STATE CHARTERED INSTITUTIONS
Consumer Finance Companies with Designated Examiners
(as of November 1971)

State	Number of Offices	Number of Examiners	Man-Days Available	Man-Days Available Per Office
Texas	2,265	16	3,840	1.70
Utah				
Vermont	380	2	480	1.26
Virginia				
Washington	270	2	280	1.77
West Virginia				
Wisconsin	468	8	1,920	4.10
Wyoming	75	1	240	3.2

Source: National Association of Consumer Credit Administrators

EXHIBIT 4-10

INSTITUTIONS SUBJECT TO EXAMINATION BY STATE CONSUMER CREDIT ADMINISTRATORS
(as of June 1971)

State	Small Loan Companies	Other Nonbanking Financial Institutions	Total	Number of Examiners
Alabama	396	516	912	5
Alaska				
Arizona	221		221	15*
Arkansas				
California	1,995	337	2,332	51[o]
Colorado	750+		750	4
Connecticut	417	10,948	11,365	10[p]
Delaware	52		52	3*
District of Columbia				
Florida	914	169	1,083	10
Georgia	1,112		1,112	12
Hawaii	212	47	259	18*
Idaho				8*
Illinois	800[q]	227	1,027	12
Indiana	781++			16
Iowa	354	378	732	4
Kansas	329	4,978	5,307	7[r]
Kentucky	451	257	708	5
Louisiana	941		941	5
Maine	63	913	976	5[r]
Maryland	340	380	720	6
Massachusetts	317	4,652	4,969	23[r]
Michigan	600	188	788	8
Minnesota	115	415	530	5
Mississippi	425	193	618	8
Missouri	580	124	704	3
Montana	65		65	1
Nebraska	208		208	1
Nevada	63		63	4
New Hampshire	88	314	402	1
New Jersey	499		499	5
New Mexico	201	155	356	1
New York	553	759	1,312	317*
North Carolina	566	122	688	5
North Dakota	44	37	81	2
Ohio	1,556	1,164	2,720	11
Oklahoma	508	2,167	2,675	4[r]
Oregon	233	62	295	2
Pennsylvania	926	7,821	8,747	22[s]
Rhode Island	105		105	5
South Carolina	682	52	734	6
South Dakota	72		72	1
Tennessee	455		455	5

EXHIBIT 4-10 (Cont'd)

INSTITUTIONS SUBJECT TO EXAMINATION BY STATE CONSUMER CREDIT ADMINISTRATORS
(as of June 1971)

State	Small Loan Companies	Other Nonbanking Financial Institutions	Total	Number of Examiners
Texas	2,265		2,265	16
Utah	77	156	233	4[t]
Vermont	33		33	6*
Virginia	380		380	2
Washington	270	69	339	2
West Virginia	204		204	12*
Wisconsin	468	2,974	3,442	8[u]
Wyoming	75		75	1
				687

* Responsible for examining all financial institutions

\+ Supervised lenders UCCC

o Responsible for examining credit unions as well

p Division performs TIL function for all lenders including banks

q Industrial loan offices licensed but operated out of small offices

++ Figure only includes small loan companies that will be subject to examination under UCCC, other supervised lenders not determined

r Division performs TIL examination for retailers or unlicensed lenders

s Responsible for 1064 Motor Vehicle Sales Finance and 1431 Instalment Sellers

t Includes premium finance companies and pawnbrokers

u Responsible for 2639 Motor Vehicle Dealer Sales Finance and 200 Sales Finance

DATA SOURCES: National Association of Consumer Credit Administrators and Conference of State Bank Supervisors

Chapter 5

CREDIT INSURANCE

The term "credit insurance" here pertains to insurance sold in connection with a consumer credit transaction.[1] It covers the life and/or health of the debtor as distinct from property insurance sold to debtors to protect creditor's equity in big ticket items—household goods and automobiles—against perils such as fire, windstorm, theft, and collision. (Fire and casualty insurance is not covered in this chapter.)

The two basic types of personal credit insurance are life and accident and health. Credit life insurance insures the creditor against loss if the debtor dies. Credit accident and health insurance insures the creditor against loss if the debtor is disabled and cannot make payments. Both assure the debtor that the debt will be paid and that dependents will be freed of the obligation.

Debtors seem to accept credit insurance. An Ohio University research group surveyed debtors, and asked "If you were to borrow money in (the) future, would you want the amount of the loan covered by credit life insurance?" More than 90 percent of the respondents answered "yes."[2] An almost identical question concerning health and accident insurance elicited about the same percentage of affirmative response, indicating that most debtors want credit life and credit accident and health insurance.

The Nature of Credit Life Insurance

Credit life insurance may be provided on an individual or group basis. To obtain an individual policy, the debtor must negotiate for and purchase directly from an insurance company sufficient coverage to pay the approximate amount of the outstanding debt. This typically is in the form of decreasing term insurance with the face amount of the policy declining as the debt matures or time passes.

Individual policies are rarely sold except in connection with home mortgages or similar types of instalment credit in which the debt is relatively large and the time over which instalments are to be paid is relatively long. Individual coverage is not generally available for the typical consumer instalment debt, because the relatively small size and short maturity of the debt make such coverage uneconomical.[3] Consequently, the bulk of credit life insurance in force in the United States is in group form. At the end of 1970, approximately \$88 billion of credit life insurance was in force with approximately 84 percent of it written on a group basis.[4]

Group Credit Life Insurance

The mechanics of underwriting and selling group credit life insurance are significantly different from those of individual credit life policies. Group credit policies are issued by the insurance company directly to the creditor. The group insured is a single designated class of debtors, such as credit customers of a department store or borrowers from a consumer finance company. Each member of the group typically owes a relatively small amount of instalment debt with a short maturity, usually 5 years or less.

The typical group credit life policy provides that upon the death of the insured debtor, the insurance company will pay the unpaid balance of the obligations. The creditor-policyholder is the beneficiary. Since the policies provide decreasing term insurance for each member of the group, the amount of insurance for each member declines with reduction in the balance of the debt, and the benefits usually equal the debt. If the debtor becomes delinquent in payments and stays delinquent for a specified period of time, the policy usually provides for automatic termination. If the policy did not so provide, the insurance company could find itself exposed to an adverse selection of risks; for a creditor could continue to pay premiums for insured delinquent debtors whose deaths were imminent, and stop paying premiums for all other delinquents.

Group credit life insurance policies usually stipulate a limit on the amount that may be written on one insured debtor. If the creditor extends credit in excess of the maximum coverage available under the policy, the amount of insurance usually remains at the maximum until the indebtedness is reduced to that maximum. Thereafter the indebtedness and insurance are reduced at the same rate. However, in some cases the policy provides for a proportionate reduction in insurance. In this instance, the insurance is reduced by the same ratio

as the debt. The amount of the insurance always bears the same relationship to the amount of the debt. For example, if the maximum limit for each life insurance policy were $2,000 and the creditor should lend the insured debtor $4,000, the initial amount of insurance would be $2,000. With each succeeding payment on the indebtedness, the amount of the insurance would be reduced proportionally but insurance coverage would always be equal to approximately 50 percent of the unpaid balance of the debt.[5]

Group Credit Life Premiums

Although the premium on group credit life insurance is paid by the creditor-policyholder to the insurance company, all or part of the premium cost may be passed on to the insured debtor. In some instances creditors provide credit life insurance to debtors without any identifiable specific premium charge and absorb the cost in the finance charge or the cost of the goods or services. Credit unions are an example of a class of creditors who do this. Typically, however, the debtor pays a specific and identifiable charge for credit life insurance as a separate service. It was this controversial charge—what it should be and how it should be computed—that was the focus of the Commission's interest.

Premium rates and consequent charges to debtors are usually at flat rates (rates of charge for insurance which do not vary with the age of the insured debtor or the amount of insurance written). This differs from regular life policies where the premium increases as the age of the insured increases and the face amount of the policy decreases.

Two methods of assessing premiums are the initial single premium method and the periodic billing method. The first and most common method is for the creditor once each month to compute an initial single premium for each new debt that has become insured during that month and pay the aggregate of these single premiums to the insurance company. Under this system the single premium pays for coverage for the full term of the indebtedness. The premium is usually computed at a flat premium rate per $100 of initial indebtedness per year. For example, on a $1,000 note repayable in 12 monthly instalments, the insurance premium rate might be 39 cents per $100 of initial indebtedness per year, or $3.90.

The other method of determining and collecting premiums is to charge the insured creditor a flat rate periodically, usually monthly, on each $1,000 of outstanding insured indebtedness. This method of premium assessment is typically used when premium costs are not passed on to the debtors as a specific identifiable charge. If this method is used and the charge is passed on to the debtor, the creditor may have an expensive problem with delinquent insured accounts. The creditor may pay insurance premiums on a debtor's life and never collect the premiums from the debtor.

State laws generally provide that any charge made to a debtor for credit insurance may not be more than the actual premium paid by the creditor to the insurance company. The creditor is not allowed to take a "markup" on the premium, and normally does not receive a commission. That fee is usually paid to a licensed agent of the insurance company. The creditor, to whom the master policy is issued, receives his compensation in the form of "dividends and/or rate credits when earned, based on the experience of the group."[6] The amount of that compensation depends on (1) the claims experience of the insurance company with the creditor's particular group of debtors and (2) the size of premium charged. If the insurance company has a large margin of underwriting profit (the difference between premiums collected and claims paid) the dividends or rating credits payable to the creditor are large and *vice versa.* This method of computing compensation provides the incentive for creditors to select those insurance companies that charge high insurance premiums, because high premiums tend to result in proportionately higher compensation. This conflict of interest, the focal point of the controversy, is the basis of the demand for specific regulation of all credit insurance rates and/or sales.

Credit Accident and Health Insurance

Credit accident and health insurance also offered in connection with consumer credit transactions provides for payment of insured debt instalments falling due while the debtor is disabled. It, too, is nearly always written on a group basis[7] and marketed like group credit life insurance. The major difference between these two types of insurance is that a wider range of plans is available under group accident and health.

Credit accident and health policies have two distinctive features that affect premium costs, (1) the qualification period and (2) the method of determining benefits. Under almost all credit health insurance plans benefits do not accrue until the insured has been disabled for a period of from 14 to 30 days. Sometimes the plan provides that benefits are retroactive to the first day of disability, provided disability has continued past the 14 to 30 day qualification period. However, if benefits are not retroactive, they are payable only for the period of disability occurring after the qualification period.

Another difference between credit life and credit accident and health insurance is the method of determining the amount of benefits to be paid. Under a credit life policy, full benefits are payable on death. Under a

credit accident and health policy, one of two quite different methods of determining benefits is usually stipulated. The most commonly used is the pro rata method which provides that the insurance company will pay 1/30th of a monthly instalment for each day the insured debtor is disabled for less than a month, and, of course, full instalments for each full month of disability. The other method provides for a benefit equal to the full monthly payment if the insured is disabled on the monthly payment due date. Under either method payments continue as long as the debtor is disabled up to the contractual maturity date of the debt.

The insurance company charges a flat premium rate for all borrowers regardless of age, as with credit life insurance. The master policy is issued to the creditor who in turn sells the insurance to debtors. In providing credit accident and health coverage, creditors have the same conflicts of interest they have with credit life insurance. The creditor's compensation is a function of the charges to insured debtors for the insurance coverage. The higher the charges, the greater the creditor's compensation and *vice versa.* As a consequence, some type of rate regulation has been demanded for this type of coverage, just as it has been for credit life insurance.

Why Any Direct Compensation?

Senator Philip Hart and others have asked why a creditor should receive any direct compensation or profit from the sale of credit insurance. The justification for compensation to the creditor is that the creditor performs valuable third party services for the insurance company and the debtor. These services result in savings to the insurance company which are in turn passed on to insured debtors. This can be proved by comparing the premium for a credit insurance policy written on a group basis with one written on an individual basis. The cost of coverage is almost always less when written on a group basis. In many cases the debtor does not have a choice because few companies sell credit life insurance on an individual basis, and none sell it on an individual basis at reasonable rates.

What services are performed? First, the creditor "acquires or sells" the insurance either for no commission or a lower one than if an agent were used. Acquisition costs (e.g. sales commissions) are a major cost for the life insurance company when an individual policy is sold. Second, the creditor issues the evidence of insurance to the debtor, collects premiums, and handles other routine tasks of policy administration. The insurance company may make periodic audits to determine if the creditor is complying with group policy terms and legal requirements, but most administrative tasks are performed by the creditor. Finally, the creditor handles claims administration. Evidence of death or disability is submitted to the creditor who usually assists in completing the claims form and forwards it to the insurance company. Then, the company pays the creditor-beneficiary who in turn remits any proceeds in excess of the debt to the debtor's estate (under a life policy) or to the insured (under an accident and health policy).

The controversial areas associated with credit insurance may be classified as (a) nonrate abuses and (b) adequate rates. Nonrate abuses include such things as (1) selling excessive coverage, (2) failure to refund to debtors unearned premiums, (3) failure to inform debtors of their coverage, (4) pyramiding of coverage and (5) coercion of debtors to purchase insurance.[8] Correction of most of these problems is primarily, though not exclusively, a matter of adequate legislation and enforcement. That these practices are "abuses" is not the subject of much controversy. Chief Counsel Robert A. Miller of the Pennsylvania Insurance Department writing on enforcement experience indicates widespread violations of the laws and regulations in that state.[9]

The second basic problem in the regulation of credit insurance involves establishing proper rates for credit life and credit accident and health insurance. The controversy continues because there is merit to several contending positions.

The Problems

Sale of credit insurance by creditors to debtors for profit has been at issue for 15 to 20 years with controversy stemming from two basic factors. The first is that the creditor has a conflict of interest in the purchase of group credit insurance from the insurance company. The creditor's compensation is directly related to the premium charged for the group credit insurance: the higher the insurance premium, the larger the creditor's compensation or profit for the services he performs. Consequently, the contention is that the creditor will tend to select group life policies with the highest premiums—a form of "reverse competition."

The second factor is that the debtor has no real alternatives in selecting credit life or credit accident and health insurance. The purchase of credit life or credit accident and health insurance on an individual basis is uneconomical and, by age group, would cost the debtor considerably more than if purchased from a creditor on a group basis. Consequently, the debtor's choice is to purchase the insurance from the creditor or not purchase it at all.

The creditor is in an unusually powerful position to "persuade" or "sell" credit insurance to debtors. This is probably more likely in the cash credit (loan) segment of the market than in the sales credit segment because the

typical cash borrower normally has fewer alternative sources of credit available than the credit purchaser.

The debtor is usually in an inferior bargaining position with the creditor. The creditor or lender usually will not openly and directly state that the purchase of credit insurance is required for a loan or credit purchase. This is particularly true since the Truth in Lending Act (TIL) became effective, because under TIL if credit insurance is required, the premium must be included in the finance charge and, therefore, in the annual percentage rate. However, it seems probable that subtle pressure is used in the sale of the insurance to debtors, evidenced by the unusually high percentage of debtors who purchase insurance. It is not unusual for cash lenders to have an "insurance penetration" of 95 to 98 percent. Even in light of the indicated preference of borrowers for these coverages, these high percentages of acceptance of insurance indicate that some coercion is probably used.

Of course, debtors have no compelling reason to resist this pressure, because the cost of credit insurance is usually relatively small in relation to the total amount of the average consumer credit transaction. The relatively small cost and the high level of acceptability of credit insurance tend to make this insurance relatively easy to sell.

Normally, when buyers of goods or services are fully informed of the price, terms, and conditions of a transaction, competitive forces will establish a "fair" price for the item, assuming the buyer has alternatives. The problem with credit insurance is that even when informed debtors have no real alternatives in selecting coverage and are in a vastly inferior bargaining position *vis a vis* the creditor. In addition, the relatively insignificant cost of the added insurance service discourages debtors from engaging in intense price shopping.

Because the creditor's interests tend to lie in higher credit insurance rates rather than the lowest obtainable rates, and because the economic factors are such that debtors cannot or will not shop for credit insurance, there is considerable pressure and probable justification for governmental regulation of rates.

The problem is not whether there should be regulation of rates but what type and how much regulation is needed. The extreme positions regarding rate regulation are represented by some who believe that credit insurance rates should be determined competitively and by others who feel strongly that the creditor should not only be required to sell credit insurance on a nonprofit basis but that he has a "fiduciary" responsibility to obtain the lowest possible rates. The creditor's obvious conflict of interest would make competitively determined rates unlikely. Consequently, some type of regulation is necessary to help encourage competition.

Relative Benefit Position

Some suggest that a possible solution to the problem of regulating credit life and credit accident and health insurance rates is to forbid creditors from making any profit from the sale of the insurance.[10] The basis for believing creditors would continue to provide this coverage on a nonprofit basis is that creditors benefit from credit insurance coverage even if they derive no profit from its sale. There is no question that creditors would benefit because the insurance indemnifies them against loss of amounts owed by debtors who die or become disabled. Then why not adopt this approach as the solution to the problem? It has two major shortcomings.

First, if creditors were not allowed to profit from the sale of credit insurance, the number of creditors offering the coverage would likely decline. Inevitably, as the number of debtors covered by various group insurance plans declined, the unit costs and price of this insurance would rise. The price of credit insurance on a nonprofit basis could conceivably be higher than it is on a profit basis.[11]

Second, this nonprofit approach, as most other approaches to the regulation of credit insurance, changes the economic nature of the credit insurance transaction. The basic error in the nonprofit approach is the implicit assumption that the consumer credit transaction yields, or would yield, a reasonable return to the creditor without the profit from credit insurance. Considerable evidence indicates that this would not be the case. For example, the 1971 composite financial report of the regulated consumer finance companies operating in Missouri indicates that without income from credit insurance these companies in the aggregate would have operated at a loss for that year.[12] It would be unrealistic to assume that cash lenders would continue to offer credit insurance if they were prevented from making a profit. Indeed, it might be that cash lenders, under such circumstances, would not only discontinue offering insurance services but cease or severely restrict offering financing services as well.

The Alternative Cost Position

Some believe that even the higher unregulated rates, such as $1.00 per $100 or $1.50 per $100 per year, for consumer credit insurance are not as onerous as many proponents of regulation would have the public believe. Group credit insurance sold by creditors to debtors even at such relatively high rates, they maintain, is less costly than similar coverage bought by the debtor on an

individual basis. This contention is correct for anyone over age 40 as demonstrated by the comparative rates for individual decreasing term life insurance shown in the following table.

Single Premium Rates for $100 Initial Coverage, Monthly Decreasing Term Life Insurance for 12, 24, 36 and 60 Months at Various Ages.

Ages	12 months	24 months	36 months	60 months
18-25	$0.46	$0.638	$0.813	$1.159
26-30	0.481	0.679	0.877	1.276
31-35	0.53	0.776	1.027	1.548
36-40	0.659	1.036	1.433	2.293
41-45	0.948	1.596	2.273	3.715
46-50	1.394	2.467	3.587	5.972
51-55	2.123	3.878	5.693	9.516
56-60	3.265	6.070	8.970	15.020
61-65	5.006	9.377	13.762	22.539

Source: American Banker Life Assurance Company, Miami, Florida

Rates for group credit life insurance range from the recommended rate of 60 cents up to 75 cents per $100 of coverage for 12 months.[13] Rates for individual coverages shown in the table would be higher than group rates for debtors over age 40 while such rates would be lower than group rates for the younger debtors.[14] Thus, it appears that younger debtors are subsidizing the credit insurance coverage for older debtors. Even with the suggested group rate of 60 cents per $100, a borrower 35 years old or younger could purchase credit life insurance on an individual basis more cheaply than on a group basis.

The effects of this apparent subsidy of older debtor's insurance by younger debtors may have greater significance in the regulation of credit life insurance rates than is apparent at first glance. If life insurance companies and creditors are required to write credit life insurance at flat rates of 60 to 75 cents of $100 initial coverage, they could increase their profit simply by being more selective in their risks. For example, creditors could establish a rule that no credit would be extended to persons over age 40 and eliminate higher risk older debtors. The lower flat rate recommended by the National Association of Insurance Commissioners (NAIC) and others would tend to reduce cost of credit insurance to younger debtors and deny it to older debtors. To overcome this deficiency, some suggest that a regulation be promulgated requiring creditors to offer credit insurance to all debtors. But the probable result of such a regulation might be that creditors would refuse credit to older debtors because transactions with them would be marginally profitable.

Actuarial Cost Position

The approach to regulation of credit insurance rates with the greatest appeal and widest acceptance in determining the allowable charge for credit life and accident and health insurance is the actuarial cost of the insurance plus a "fair" profit approach. It seems reasonable to determine the "actual" cost of the insurance, add a "fair" profit, and let the result be the rate.[15] But administrative problems in applying this approach make it unacceptable to creditors and insurance companies, and, in fact, they use a drastically modified version of the "true" cost plus a "fair" profit approach.

True actuarial cost credit insurance would involve a study of the mortality or morbidity costs, servicing costs, and overhead costs of the insurance. It is obvious that the mortality or morbidity costs would increase as the age of the debtor increased, and rates for insurance for older debtors should be higher than for the younger. Similarly, rates for smaller initial debt balances should be relatively higher than for larger initial balances, because a fixed cost is involved with overhead and servicing of the policy. The resultant rate structure would involve progressively higher insurance rates as the age of the debtor increased or the size of the initial debt decreased.

For the most part, regulatory authorities have decided that the variable rate structure allowing for differences because of amount of debt and the age of the debtor is too unwieldy and complex. The NAIC has recommended that a flat rate system be adopted by the

496-072 O - 73 - 8

various state regulatory bodies using "a single minimum loss ratio standard for all credit life insurance transactions irrespective of the size and the maturity" of the indebtedness and the age of the debtor. An NAIC staff study recommends that all credit insurance rates allowed, accident and health, as well as life, should result in a 50 percent minimum loss ratio. Credit insurance rates for a particular company should be adjusted upward or downward to conform with this standard or benchmark of a 50 percent loss ratio. The basic advantage of the flat or single rate system of regulation using a basic loss ratio is its simplicity. Regulatory authorities as well as insurance companies and creditors could easily understand what the permissible rate of charge for the credit insurance should be. The underlying assumption behind the minimum 50 percent loss ratio benchmark is that if the claims expense is equal to approximately 50 percent of total premiums collected, the remaining 50 percent, on the average, would be sufficient to defray other costs associated with the insurance and provide a reasonable profit to the insurance company and the creditor. This 50 percent loss ratio benchmark was recommended by NAIC for use by the various states in setting both credit life and credit accident and health rates according to the model bill.

There may be loopholes in the 50 percent minimum benchmark loss ratio when used in connection with accident and health insurance. The benchmark was developed primarily from studies of credit life insurance where the benefits were relatively fixed and the resultant premium developed would be relatively constant. However, with credit accident and health insurance, there are a number of different variations in plans, such as the length of time in the qualification period and provisions for retroactive benefits. The creditor can increase his profit by selecting a credit accident and health plan with a shorter qualification period and retroactive benefits which would produce higher claim costs and higher premiums. These higher premiums result in greater profits to the creditor. The following table presents a comparison of the balances available for the dividend or rating fund from which the creditor is compensated. One credit accident and health plan is based on a 30-day qualification period with nonretroactive benefits; the other plan provides a 14-day qualification period and retroactive benefits.[18]

The balance available to a creditor for the 30-day nonretroactive plan is about the same as for a credit life plan. However, if a creditor decided to increase the benefits which would result in an increase in premium as with the 14-day retroactive plan, the balance available for the creditor's expense and profit nearly doubles. The creditor's costs in providing these insurance coverages are relatively fixed and therefore these increases in balances would be mostly profit.

The flat rate premium derived from the 50 percent minimum loss ratio has flaws and results in inequities to debtors, creditors, and insurers. As pointed out earlier, under a flat rate system, younger debtors are subsidizing older debtors' credit insurance, because younger debtors have lower mortality (claim) costs. The creditor who has credit outstanding involving principally small average balances, short maturities, and older debtors would be penalized under a flat rate system compared with any competitors whose portfolios included larger average balances, longer maturities, and obligations of younger debtors.

To overcome some of the inequities of the flat rate system, the preliminary report of the Consumer Credit Life and Disability Insurance Study at Ohio University recommended a variable rate structure for credit life

	Life	A & H 30-Day Nonretroactive	A & H 14-Day Retroactive
1. Automobile loan for $3,000 - 36-month duration			
Total Charge	$54.00	$63.60	$125.40
Benefits	-27.00	-31.80	-62.70
Insurer's Retention	- 5.40	- 9.54	-18.81
Balance	$21.60	$22.26	$ 43.89
2. Small loan $500 - 24-month duration			
Total Charge	$ 6.00	$ 8.70	$ 17.65
Benefits	- 3.00	- 4.35	- 8.83
Insurer's Retention	- .60	- 1.31	- 2.65
Balance	$ 2.40	$ 3.04	$ 6.17

insurance based on the "cost and profit elements of the credit life insurance transaction."[19]

The variable rate structure system proposed by that study does not consider all cost elements in the derivation of rates because the formula used to determine rates took into account only operating overhead costs, acquisition costs, and servicing costs, plus a flat rate for mortality or claim cost. Variability of the rate stems from the fact that acquisition and servicing costs decline proportionally as the size of debt and length of time to maturity increase.

The formula used to determine the insurance rate (P) per $100 of initial indebtedness per year is:[20]

$$P = \frac{4}{3}\left(\frac{A}{ML} + \frac{S}{L} + C\right)$$

A = creditor acquisition cost for each insurance transaction = $1.50

S = creditor servicing cost per year = 66 cents

C = claim cost per $100 of initial indebtedness per year = 30 cents

M = maturity of the underlying credit extension in years

L = size of the underlying credit extension in $100 units

It should be noted that this formula does not take into account variable costs associated with mortality because it provides a mortality or claim cost factor of 30 cents per $100 of initial indebtedness per year irrespective of the age of the insured. While in no sense a "true actuarial rate," it does capture all of the variables except mortality.

It would be more equitable to set maximum allowable credit insurance rates on the basis of various costs of the insurance transaction than to use the flat rate system now employed. Such an insurance rate structure contemplates broad categories of allowable rates, taking into account differences in age, size of debt, and length of maturity of debt. For example, one rate would be set for all creditors between ages 20-29, a higher rate for creditors between 30-39, and so forth.

Similarly, variable rates should take into account differences in size of debt and length of maturity as suggested by the Ohio University study. But as a practical matter, the number of rate categories proposed in that study should be reduced. The study recommended a different rate for each $250 increase in the size of debt and for each 6 months in maturities. The full rate schedule called for 96 separate rates. While this variable rate system has merit, for simplicity's sake the breakdown should be less detailed with fewer specific rate classes.

The Commission recommends that the finance charge earned by credit grantors should be sufficient to support the provision of the credit service. If this goal is achieved by the states, charges for all forms of credit insurance should be set at a level to permit the provision of this service, without subsidizing the finance service or being subsidized by the income received from providing the finance service. In short, credit insurance should stand "on its own feet."

The Commission had neither the time nor the resources for a study to determine a "proper" loss ratio or level of charges for all of the various forms of credit insurance and differences among policyholders. Its review of the literature and of Congressional hearings gives reason to believe that rates on various forms of credit insurance are too high in many states.

The Commission recommends that the proposed Bureau of Consumer Credit in the Consumer Protection Agency make a study to determine acceptable forms of credit insurance and reasonable levels of charge and prepare recommendations.

The Commission also recommends that the states should immediately review their own charges for credit insurance and lower rates where they are excessive.

The Commission further recommends that creditors offering credit life and accident and health insurance be required to disclose the charges for the insurance both in dollars and cents and as an annual percentage rate in the same manner as finance charges and annual percentage rates of finance charges are required to be disclosed under the Truth in Lending Act and Regulation Z. The amount of premium and the corresponding percentage rate should be set forth clearly and conspicuously on the Truth in Lending disclosure statements just below the annual percentage rate of finance charge. In that way, consumers will be told the charge for credit insurance, assuming the creditor offers credit insurance, in the same way they are told the finance charge. Such disclosure, particularly in credit advertising, should help provide a competitive market in credit insurance.

Chapter 6
RATE CEILINGS

The Commission focused a substantial amount of its attention and devoted a large share of its resources to a study of the adequacy of existing arrangements to provide consumer credit at reasonable rates.

Basically, there are two conflicting views on how to assure reasonable rates for consumer credit transactions. Some support "free rates," arguing that prices of credit should be established by the market unhindered by direct government interference. Others support "decreed rates," opting for price ceilings on consumer credit. Spokesmen for the two viewpoints are both numerous and dedicated. Economist Dr. Milton Friedman leaves no doubt as to his position:

> ...I know of no economist of any standing... who has favored a legal limit on the rate of interest that borrowers could pay or lenders receive—though there must have been some.... Bentham's explanation of the "mischief of the anti-usurious laws" is also as valid today as when he wrote that these laws preclude "many people, altogether, from the getting the money they stand in need of, to answer their respective exigencies." For still others, they render "the terms so much the worse... While, out of loving-kindness, or whatsoever other motive, the law precludes a man from *borrowing*, upon terms which it deems too disadvantageous, it does not preclude him from selling, upon any terms, howsoever disadvantageous." His conclusion: "The sole tendency of the law is to heap distress upon distress."[1]

But economist Leon Keyserling does not agree:

> I find it deplorable that we feel bound to set an 18 percent interest rate ceiling for these people, which is three times the rate at which (as I have cited) a powerful corporation can borrow money on bonds while many of our greatest corporations finance themselves and do not have interest costs of large significance. I think the ceiling should be very much lower... I am not going to take the position that even 12 percent is a conscionable interest rate for the kind of people borrowing money for these kinds of purposes. They ought to be able to borrow for much less, even if this requires new public programs.[2]

These differing viewpoints have existed for centuries.

HISTORICAL BACKGROUND

The basic economic choice of setting prices by a free-market approach or by a price-control approach has been faced from the time of the first loan of grain, or an animal, or food. Historical review suggests that each society has had to "reinvent the wheel" in dealing with the issue and has not learned appreciably from earlier efforts. Current attitudes about the use of credit by consumers and the prices they should pay for it are conditioned by a long history of Biblical injunctions against the taking of interest. The origins of society's views on interest rates help to explain some of the deep feelings about this economic issue.

Ancient times

Records of primitive societies show rates for the use of rice, shells, blankets, and cattle ranging from 100 to 300 percent.[3] One of the first attempts to limit the maximum rate of interest was in the 24th century B.C. when the Laws of Manu in India set 24 percent as the established rate.[4] During the Babylonian period (1900 - 732 B.C.) the Code of Hammurabi set a maximum annual rate of 33 1/3 percent for loans of grain and 20 percent for loans of silver, although then as today there were recorded violations of the legal maxima.[5]

Annual percentage rates on personal loans in Greece in the fourth century B.C. were not limited by law; they ranged from 12 percent to 33 1/3 percent from professional money lenders but "common usurers" charged considerably more.[6] This era also foreshadowed remedial loan associations ("the temple at Delos charged 10 percent on all loans") and the credit problems of the cities (Senator Marcus Junius Brutus charged the city of Salamis in Asia Minor 48 percent).[7] During the same period the Romans attempted to limit the price of credit. In 443 B.C. the legal maximum in Rome was 8 1/3 percent although market rates were evidently higher. The price ceiling on credit was fixed at 4 1/6 percent in 347 B.C. but this ceiling was even more frequently breached.[8] During 10 centuries beginning with the fifth century B.C., ceilings on the price of

credit in Rome ranged from a prohibition of the taking of interest to 12 1/2 percent. Actual rates charged varied with the same market forces of demand and supply common today and were limited, if at all, more by tradition than by legal ceilings. There were also, as today, "pawnshop rates and 'loan shark' rates which [were] far higher than the 'normal' rates."[9]

Religious Prohibitions of Usury

The contemporary meaning of "usury" differs from its use in the Bible and in medieval Europe. Originally, usury "signified a payment for the *use* of money itself,"[10] whereas today usury is viewed as the taking of a greater rate of interest than the law allows. The Biblical injunction against usury was very simple: Do not take back more than is given.

> And if thy brother be waxen poor, and fallen in decay with thee; then thou shalt relieve him: yea, though he be a Stranger, or a sojourner; that he may live with thee.
>
> Take thou no usury of him, or increase: but fear thy God; that thy brother may live with thee.[11]
>
> Thou shalt not lend upon usury to thy brother; usury of money, usury of victuals, usury of anything. . . Unto a stranger thou mayest lend upon usury; but unto thy brother thou shalt not lend upon usury.[12]

Because the original Biblical meaning of usury was synonymous with modern-day "interest," the effect of the Biblical injunction was to prohibit the taking of any return for a loan of money—or the loan of anything. The origin of this doctrine lay in the belief that it was morally wrong to profit from the distress of a necessitous borrower. Restrictions against usury received support in medieval and renaissance Europe from both church and state. St. Ambrose (340-397) argued that usury was acceptable only when used against the "foes of God's people" who could also be acceptably killed, and the Capitularies of Charlemagne (circa 800) forbade usury.[13] Prohibitions against usury were more strictly codified in 1139 by the Second Lateran Council. Even the time-price doctrine (which, of course, did not exist in that era) came under prohibition when Pope Alexander III (1159-1181) "declared that credit sales at a price above the cash price were usurious."[14]

Such artificial prohibitions against the taking of any interest combined with pressures for credit by consumers and commercial interests set into motion a number of reactions.

First, there were outright violations of the usury limitations, although the sin of usury was not viewed lightly. Private pawnshops existed in medieval Europe with rates ranging from 32½ percent to 300 percent and some "illegal lenders" charging as high as 1300 percent per annum. In the Low Countries during the 12th century usurers were licensed at substantial fees by the State which then proceeded to stamp out competing unlicensed lenders[15] (an early version of modern convenience and advantage licensing for consumer finance companies in some states).

Second, an effort was made in the latter half of the 15th century to provide charitable or remedial loan facilities for the poor. Developed in the tradition of the temple of Delos in ancient Greece, these facilities were early forerunners of the Provident Loan Society, established in 1894 as "New York's great 'philanthropic pawnshop.' "[16] The public pawnshops established by papal governors have been described as follows:

> A *mons pietatis* was a public pawnshop, regularly financed by charitable donations and run not for profit but for the service of the poor. It charged a small fee for its care of the pawns and for the expenses of administration, including the salaries of its employees, so that the capital would not eventually be exhausted by the costs of the business. In Italy this fee came usually to 6 percent, as compared with the 32 1/2 to 43 1/2 per cent charged by public usurers. The directors of the *mons* were usually one or two ecclesiastical representatives and several respected merchants of the town.[17]

Third, while the public pawnshops represented an important attempt to provide credit to necessitous borrowers through charitable organizations, sanctioning of them by the 16th century Popes was a significant break in the rigid definition of usury as the taking of *any* return for the loan of money. Theologians reasoned that repayment of borrowed money that exceeded the original principal was not usury but compensation for the costs of operating the *mons pietatis*. This redefinition of usury was expanded by medieval schoolmen who reasoned that the lender should be compensated not only for expenses but also for what today would be termed the lender's cost of capital—the return earned by placing funds in investments of similar risk. Conclusions of the medieval schoolmen may be summarized:

> . . . first, the poor and needy are deserving of loans consistent with the costs and risks involved in making them; and second, that if loans are to be made, there must be incentives for capital to be rewarded on a competitive basis with other market opportunities.[18]

By the 16th century credit was widely used and accepted and a competitive market for capital emerged. Usury became defined as the taking of *excessive* interest rather than the taking of *any* interest. Between 1822 and

1836 the Holy Office of the Catholic Church "decreed that all interest allowed by law may be taken by everyone."[19] It was not, however, until 1950 that Pope Pius XII "declared that bankers 'earn their livelihood honestly.' "[20]

Although the taking of interest became acceptable, Biblical doctrines were not easily forgotten. England decreed maximum rates of 8 percent (1624-1651) and 6 percent (1651-1714).[21] These 17th century rates, brought to the Colonies, remain in many U.S. state laws and constitutions today even though all English usury statutes were repealed in 1854.[22]

Origins of Rate Ceilings in the United States

The American Colonies and their successor states followed the path taken by Massachusetts in 1641 when it adopted a general usury statute fixing maximum rates at 8 percent. They failed to follow Massachusetts' lead in 1867 when it repealed its usury laws. Today only Massachusetts and New Hampshire have no general usury statutes or constitutional provisions decreeing a maximum interest rate although both states have statutes, such as small loan laws, that limit finance charges on specified forms of consumer credit.

As it became apparent that credit could not be extended to consumers, or even to many commercial borrowers, at decreed rates of 6 to 8 percent, two processes evolved to circumvent these price ceilings.

First, the time-price doctrine was developed. Essentially, this was a legal principle permitting a seller of goods and services freely to establish two prices, a cash price and a time, or credit, price. Under common law the differential was not considered interest subject to general usury statutes. So, sales credit—credit extended in conjunction with the sale of merchandise—became exempt from general usury statutes which facilitated its growth.[23] Since 1935 many states have enacted legislation limiting the time-price differential on the credit sale of motor vehicles and other consumer goods as well as on revolving credit.

Second, numerous exceptions to general usury statutes were permitted for various forms of cash credit that could not otherwise have been accommodated. These exceptions opened up *legal* alternatives to unregulated *illegal* lending that flourished in America in the late 1800's and early 1900's in spite of usury laws that presumably protected consumers. One report showed 139 active loan offices—all illegal—in Chicago in 1916.[24]

The first modern small loan bill, authorizing a maximum annual rate of 36 percent on $300 loans, was passed in New Jersey on March 13, 1914 with the support of the Russell Sage Foundation. Similar legislation eventually passed in most of the 50 states. The first law establishing credit unions was enacted in Massachusetts in 1909.[25] Similar credit union laws were eventually enacted in most states and at the Federal level as well. Arthur J. Morris devised a means of making cash loans to consumers through a combination of a direct loan and a hypothecated deposit that provided an effective return of about 17 percent, even if state usury statutes set a rate ceiling on credit of 6 percent. The first Morris Plan company began in 1910 in Norfolk, Virginia.[26] Commercial banks entered the field of consumer credit much later. The National City Bank in New York was among the first to organize a personal loan department in 1928. Eventually about 40 states enacted special enabling laws permitting loans by Morris Plan companies—or industrial banks as many were called—and commercial banks at rates above the general usury statutes. More recently special statutes have been enacted to permit banks to make check-credit loans and to offer retail revolving credit.

Not just consumers were considered in enacting exceptions to usury laws. A host of exceptions were made to accommodate the needs of industry and commerce. Some 30 states exempt FHA-insured home mortgage loans.[27] Thus, legislators, "though so far unwilling to completely repeal usury laws, have filled the statute books with exemptions which have taken care of many of the situations in which usury laws interfered with lending operations."[28]

Concluding a chapter on "Usury Doctrines and Their Effect," Sidney Homer remarks upon the continuing controversy between those advocating decreed rates and free rates on consumer credit transactions:

> The controversy did not end with the Reformation and the modification of Church doctrine. It continued and continues. It is now couched largely in terms of justice and expediency, laissez faire or economic controls, controlled rates (supposed to be low) versus free rates (supposed to be higher). . . . The rate of interest in twentieth-century America is often limited by law. It is still a subject of controversy, not only among economists, but equally among politicians and economic groups. Some like it high; some like it low.[29]

Such conflicting points of view are reflected in laws affecting consumer credit both in the United States and abroad.

CURRENT EFFORTS TO PROVIDE CONSUMER CREDIT AT REASONABLE RATES

United States

Review of the sequential development of legislation affecting the rates charged for various forms of consumer credit in the United States indicates that most states have chosen to enact a great variety of rate ceilings on most forms of credit. In contrast to the approach adopted by most other developed countries, the states generally have adopted a decreed-price approach to the problem of assuring reasonable rates on consumer credit transactions. These varying rate structures have created substantial barriers to entry and diminished competition.

A compilation of consumer credit legislation[30] reveals the present hodgepodge of legislation characteristic of most states. As one example, New York has separate statutes regulating instalment loans by commercial banks, loans by industrial banks, bank check-credit plans, revolving charge accounts, motor vehicle instalment sales financing, instalment financing of other goods and services, insurance premium financing, loans by consumer finance companies, and loans by credit unions. The general usury rate is 6 percent: (currently 7 1/2 percent under special rule of the Banking Board), and criminal penalties apply if interest is over 25 percent.[31] But the decreed maximum rates to obtain $500 of credit, repayable monthly over 12 months, range widely: bank personal and improvement loans, 11.6 percent; industrial banks, 14.5 percent; used cars up to 2 years old, 17.7 percent; used cars over 2 years old, 23.2 percent; small loan companies, 24.8 percent; other goods, 18.0 percent; retail revolving credit 1 1/2 percent on monthly balances up to $500 and 1 percent monthly on balances in excess of $500.

The variety of rate ceilings that has developed on an *ad hoc* basis creates barriers to competition among segments of the consumer credit industry. Given a maximum rate of 11.6 percent in New York, commercial banks will not enter the $500-loan market served by consumer finance companies at 24.8 percent.

The Commission has noted the recent rush by banks or bank holding companies to acquire finance companies. For example, Bankers Trust New York Corp., the parent corporation of Bankers Trust Company, agreed to acquire Public Loan Company, a New York based firm with 61 offices located primarily in New York and Pennsylvania[32] where banks are limited to a maximum of 6 percent discount on instalment loans (11.6 APR on a 12-month loan). By purchasing the finance company through its holding company, Bankers Trust will enter a consumer credit field previously denied it, in effect, by statute. Cash borrowers in the two states would have been significantly better off if banks had always been able to charge the same rates permitted licensed lenders. The added competition could only benefit cash borrowers.

Market segmentation created by rate ceilings has been made even sharper by other restrictions on various classes of credit grantors. For example, licensed lenders in New York may lend no more than $1,400 to any one borrower, whereas banks may make consumer loans as high as $5,000. Such artificial market segmentation is blatantly anticompetitive and fosters market domination by relatively few firms.

Other countries

England bestowed on its Colonies usury limits of 6 and 8 percent, but repealed its own usury laws in 1854. The only law governing rates charged for credit is the Moneylenders Act of 1927. Chapter 10, (1) of the Act provides that

> . . . [w]here the interest charged exceeds 48 percent per annum the court is to presume, unless the contrary is proved, that the interest is excessive and the transaction harsh and unconscionable; and even where interest does not exceed 48 percent per annum this does not preclude the court from holding it excessive.[33]

This does *not* mean that there is a rate ceiling on cash loans of 48 percent. If the facts warrant a higher rate, it can be allowed—even if it is 80 percent per annum.[34] However, if the borrower brings action and the lender cannot convince the court that the costs and risk justify a rate above 48 percent, the court may reopen the transaction and reduce the rate to a proper level. Although finance rates charged on credit sales are not currently limited, the Crowther Committee recommended that the 48 percent unconscionability provision be extended to the whole field of consumer credit on credit extension up to £2,000 (about $5,200). The Committee emphasized, however, that the 48 percent does not represent the "fixing of an inflexible ceiling,"[35] but rather that rates in excess of 48 percent are prima facie excessive and the transaction harsh and unconscionable with the onus on the creditor to show that the rate is not excessive.

Canada repealed its general usury law in 1858. Its Federal Small Loans Act[36] places a rate ceiling on cash credit up to $1,500 extended by lenders other than banks and credit unions. Maximum rates permitted small loan companies range from 24 percent on $300 loans to 15.24 percent on loans of $1,500, with no limit above $1,500. So few loans are made in the $1,000 to $1,500

range that the Royal Commission on Banking and Finance recommended an increase in the rate ceiling for such loans.[37]

Finance rates on sales credit are not regulated by the national government. Only one province—Quebec—has adopted the decreed-rate approach. The rest have opted for free rates, relying on Unconscionable Relief Acts to permit the courts to determine what constitutes a "harsh and unconscionable" credit charge.[38] These Acts apply only to loan credit in five provinces; rates charged on sales credit are not limited either by decreed rates or by court tests of unconscionability. With the exception of the Federal Small Loans Act and the Province of Quebec, regulatory arrangements in Canada are similar to those in England.

Germany has neither a general usury statute nor special rate ceilings for consumer credit transactions. As in England and Canada, reliance is placed primarily on the market to set rates and the courts to remedy cases of unconscionability. Both the Criminal Code and the Civil Code contain provisions against loan sharking.[39] The provisions do not define any given rate as being usurious but indicate that a situation of unequal bargaining power giving rise to charges out of proportion to benefits received may constitute usury.[40]

In France the general usury laws define as usurious any loan whose interest is more than 1 1/2 times the interest charged generally in the credit market for loans of similar cost and risk.[41] Rate schedules on instalment sales transactions must be filed with the Counseil National du Credit, but there is no indication that rates are subject to maxima.

Belgium is one of the few European countries to limit finance charges for personal loans and instalment purchases. There is no limit on rates charged on very small extensions of credit, under 2,000 Belgian francs (about $45). The decreed rates decline from about 14 to 7 1/2 percent per annum on amounts extended up to 150,000 francs (about $3,400). No rate ceilings are set for cash loans or instalment purchases involving amounts of credit above that level.

The revision of the Austrian Instalment Credit Law in 1961 provided no rate ceilings. A few cantons in Switzerland have limited finance charges on instalment sales and small loans to 18 percent, but the Federal Law on Instalment Sales enacted in 1963 contains no price ceilings on extensions of credit.

New Zealand depends on the market to set rates charged for credit. In a recent reassessment of this position the Tariff and Development Board concluded:

> . . . Because of numerous and varying factors which might have to be taken into consideration by a supplier of finance in determining his finance charge, the Board considers it impracticable to lay down any statutory maximum for such charge. . . In any event, any possibility of excess profit taking, as distinct from a higher cost of service or risk on particular transactions, would seem to be well controlled in this country by the keen competition existing between the companies engaged in instalment credit financing.[42]

Australia imposes no rate ceilings on the use of credit but relies on the courts to reopen credit transactions to deal with unconscionable finance charges. Apart from such cases, a recent Commission there concluded that ". . . we consider that interest rates are much more satisfactorily settled by a free play of market forces."[43]

The approach taken by various states of the United States toward ensuring that consumers pay reasonable rates for the use of credit generally contrasts sharply with courses taken in other developed countries. Most states fix rate ceilings on different types of credit and credit grantors. Other industrial countries have generally rejected the decreed-rate approach and permitted rates on consumer credit transactions to be set by the free market. Recognizing the possibility of occasional unconscionable transactions, they have chosen to test these on a case-by-case basis in their courts.

PURPOSE OF RATE CEILINGS ON CONSUMER CREDIT

Although the Biblical tenets against taking *any* return for the use of credit have largely been rejected in today's society, other reasons have been advanced to justify placing upper limits on rates charged for the use of credit—rate ceilings. These reasons include:

1. To redress unequal bargaining power.
2. To avoid overburdening consumers with excessive debts.
3. To administer credit grantors as public utilities.
4. To assure that consumers pay fair rates for credit.

The rate of charge is only one of a number of features embodied in an offer of credit, just as price is only one of the considerations in the purchase of an automobile. The car buyer, for instance, is also interested in the presumed durability, availability of repair services, style, size, horsepower, gas mileage and gear ratio. The relative importance of these different features varies among consumers. This is true of consumer credit, too. If the *credit offer function* is defined as the terms and characteristics bound up with an offer of credit, some of the more important aspects to consumers might be:

CREDIT OFFER FUNCTION

– Rate of charge
– Maturity
– Down payment (if any)

– Security required (if any)
–Availability of irregular payment plans
– Willingness of credit grantors to assume risk of default
– Convenience of location
– Status of credit grantor in view of consumer
– Collection methods
– Prepayment penalty
– Delinquency and deferral charges

As with automobiles, the relative importance of different features varies among consumers. For example, Juster and Shay found that "rationed" consumers–those who wanted more credit than they were able to get–ranked long maturities relatively high in their preference scale while more affluent consumers were less concerned with maturities and more concerned with price.[44]

Complex as the credit offer function appears, consumers apparently view the choice of credit as less difficult than the selection of the item to be financed. From personal interviews with 291 consumers who purchased durable goods on credit, Day and Brandt found that only 14 percent ranked the decisions of (1) cash versus credit, and (2) credit source, as one of the two most difficult decisions. In contrast, 77 percent ranked as most or second most difficult "product decisions" (1) amount to spend on the product, (2) features or model, and (3) brand or make.[45]

In analyzing the purposes of rate ceilings and examining their impact on consumer credit, the Commission considered the following points:

(1) The rate of charge is only *one* aspect of the credit offer function. Other features are not directly affected by a rate ceiling but may be indirectly affected.

(2) The rate of charge is more important to some consumers (probably the more affluent) than others when they seek credit.

(3) Generally, but not always, consumers view the credit decision as less difficult than decisions relating to the product or service acquired. On credit purchases as well as many cash loans, the demand for credit is derived from the demand for a good or service.

To redress unequal bargaining power

Advocates of low rate ceilings on credit often argue that the unequal bargaining power of debtors versus creditors will allow creditors to charge what the traffic will bear–the ceiling rate. Support for rate ceilings is usually based on the assumption that most consumers are not knowledgeable about the complexities of finance charges, are incapable or unwilling to use Truth In Lending information, and do not shop for credit. A typical comment avers:

In most fields of consumer credit, with the exception of new car financing, creditors charge the maximum allowable rate, or close to it.[46]

Do rates rise to rate ceilings? Staff studies show that assertions that rates always rise to the ceiling are incorrect except when the price ceiling is set at or below the market rate for the particular form of credit placed under price control. Persuasive evidence that rates do *not* inevitably rise to the ceiling, available prior to establishment of the Commission,[47] has been significantly reinforced by the Commission study of rates prevailing for various forms of consumer credit during the second quarter of 1971.[48]

Data gathered for the Commission relate chiefly to the average rates (APR's) and total amounts of credit in each of 50 states. Exhibit 6-1 compares the ceiling rate in each state with the mean APR charged by commercial banks in that state for $3,000, 36-month direct loans on new cars. To illustrate the construction of the exhibit, the point circled represents data reported by commercial banks in Hawaii. The ceiling rate on new-car loans in Hawaii (under the Industrial Loan Act) is 24.85 percent. On the random sample of prevailing rates for new auto direct loans by commercial banks during the second quarter of 1971, the average (mean) APR (as defined by TIL) was 9.00 percent. Thus the point is plotted at 24.85 percent on the horizontal scale and 9.00 percent on the vertical scale. Reported prevailing rates at individual banks in Hawaii ranged from 7.21 percent to 10.64 percent.

The upward-sloping straight line represents the points at which the average rates charged for new car loans would be the same as the rate ceiling. For example, the arrow under the legend "Mean APR = Rate ceiling" points to the spot at which the mean APR and the rate ceiling are both 20 percent. If the allegation that rates always rise to the ceiling were true, all of the points plotted for the 50 states would lie along the upward-sloping straight line. This is obviously not the case. Even in the six states without a legal rate ceiling on new car credit offered by commercial banks, average rates are not higher than elsewhere in the country. In those states the average APR ranged from 9.23 percent (California) to 10.65 percent (Ohio). In half the 50 states, commercial banks reported average rates above 10.08 percent and half below.

Banks generally charge more for $1,000, 12-month unsecured loans than for $3,000, 36-month direct loans secured by new cars. This observation is borne out in Exhibit 6-2, which compares the mean APR on $1,000 unsecured loans by banks with the ceiling rates. Two points are worthy of note. First, mean APR's vary more widely under rate ceilings than in the case in Exhibit 6-1. This suggests that other considerations–credit terms,

EXHIBIT 6-1

Comparison of Mean Annual Percentage Rate Charged by Commercial Banks for $3,000, 36-Month New Automobile Direct Loan to Rate Ceiling by State, Second Quarter, 1971

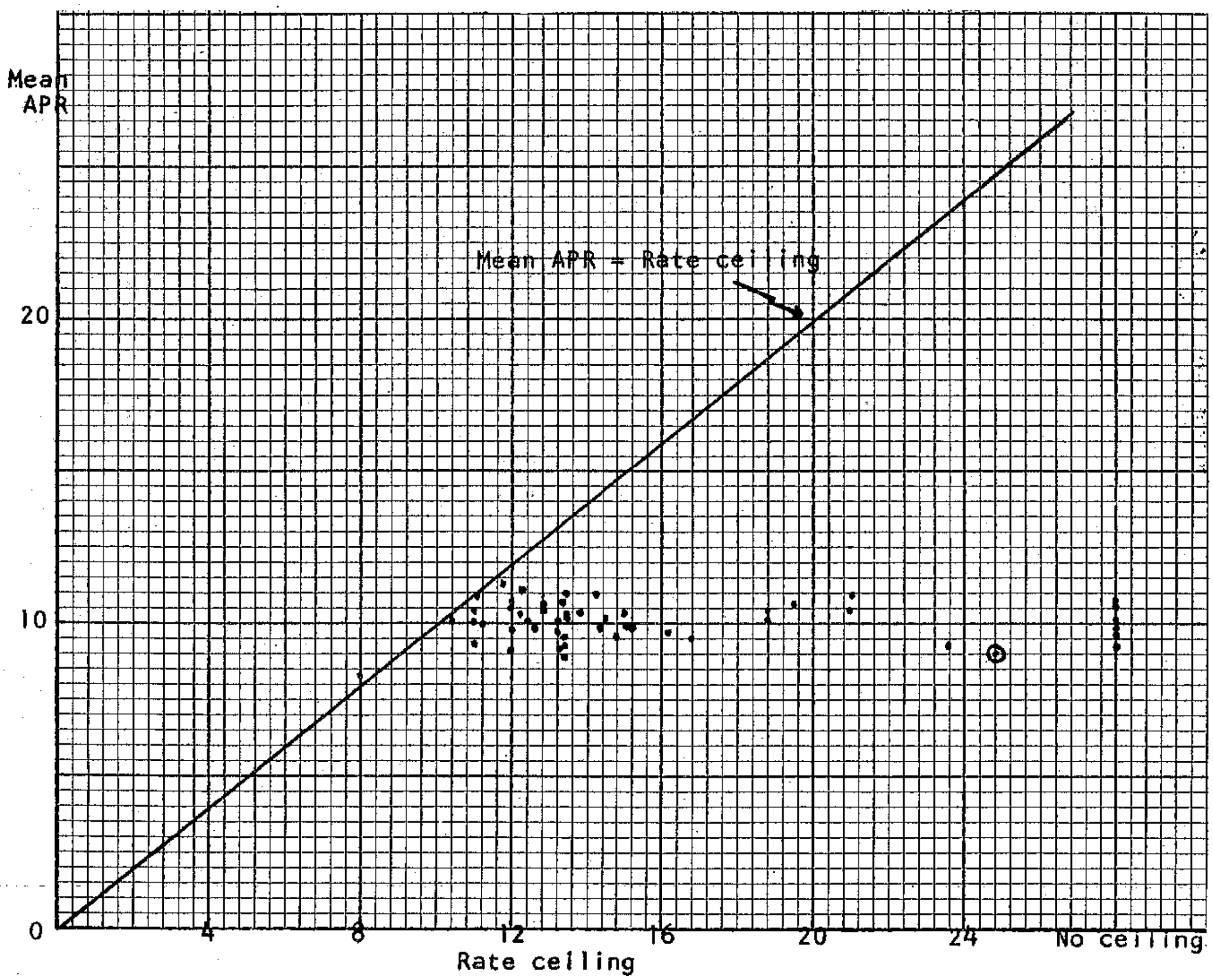
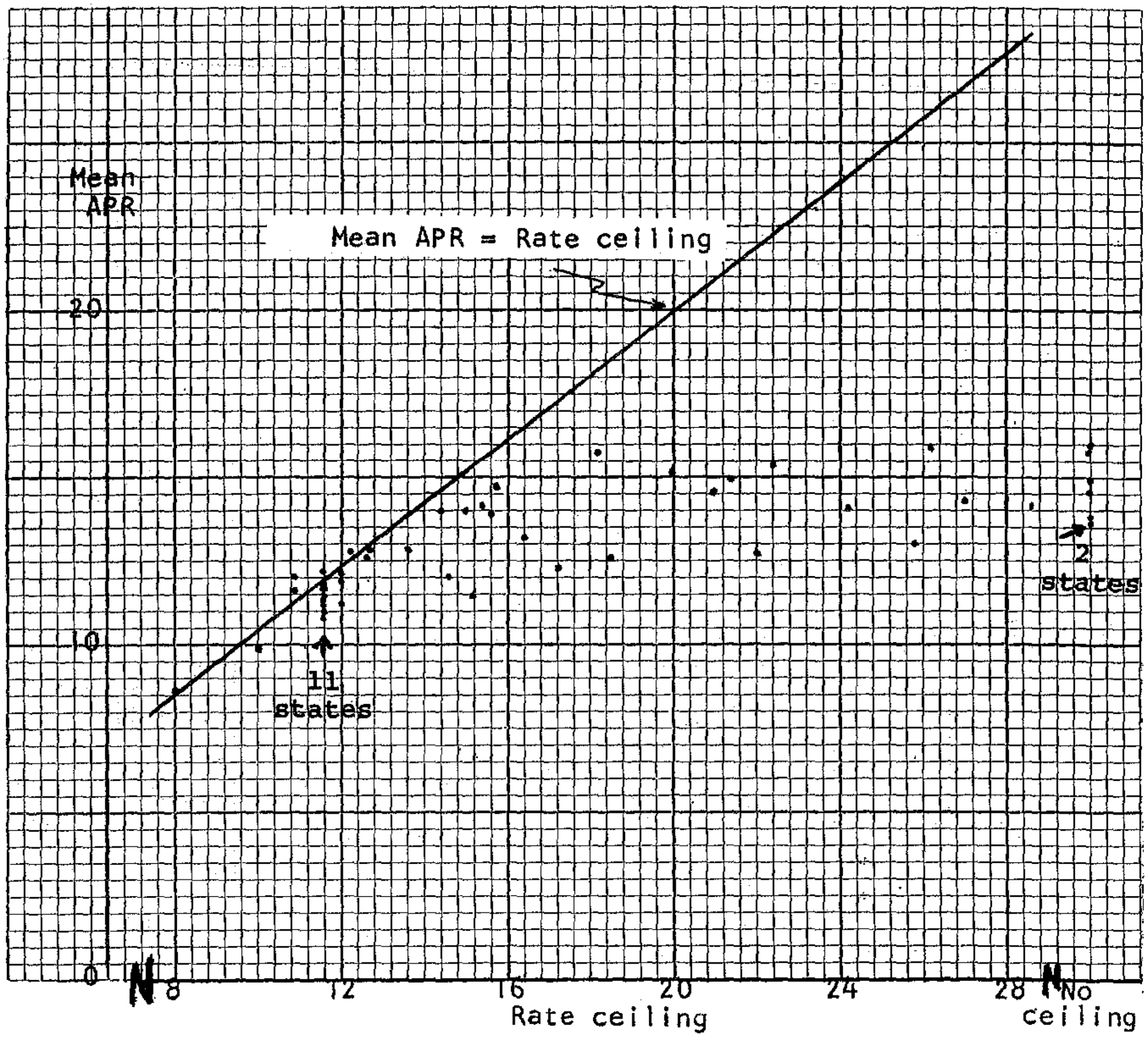


EXHIBIT 6-2

Comparison of Mean Annual Percentage Rate Charged by Commercial Banks for $1,000, 12-Months Unsecured Instalment Loans to Rate Ceiling by State, Second Quarter, 1971



borrower credit risk, and sellers' market power—may be responsible. Second, the market rates on loans of this size and type seem to lie in the range from 12 to 16 percent. Rate ceilings below that range on $1,000 loans of this quality usually approximate the rates actually charged and force the mean APR's below the other rates, as shown in the left-hand side of the exhibit. Lower decreed rates are accompanied by lower availability of loans of this type from banks. Parenthetically, Exhibit 6-2 shows that the *average* APR reported by banks for $1,000, 12-month unsecured loans in five states exceeded the legal rate ceiling.

Finance companies compete in the area of higher credit risks and succeed or fail on the basis of their skill in making personal loans to applicants who will repay and separating them from others who will probably default. At mid-1971, personal instalment loans outstanding of finance companies amounted to about 14 percent of all consumer instalment credit outstanding.

In this market, conventional wisdom would have us believe that 100 percent of instalment loans of finance companies will be at the ceiling. The belief is tested in Exhibit 6-3 which shows the percentages of personal instalment loans made by finance companies during the last 2 weeks of the second quarter of 1971 having APR's equal to or greater than 90 percent of the rate ceiling. While it is obvious that a considerable proportion of the loans are at or near ceiling rates, not all are within 90 percent of the ceiling. But there is little or no causal relation between the height of finance company personal loan rate ceilings and the proportion of loans equal to or greater than 90 percent of the ceiling.

When a rate ceiling is set at or below the market rate, rates actually charged are likely to be near or at the ceiling. For example, when rate ceilings are set at customary market rates, as with the 18 percent rate ceiling on revolving credit in many states, significantly lower rates would not be expected. Review of data gathered by the Commission shows rates on $100 revolving credit balances commonly at or near 18 percent per annum, as disclosed by TIL, except in those states where an even lower price has been decreed.[49]

Findings thus far are summarized as follows:

(1) If the legal rate ceiling is set above the market rate, the market rate prevails and average rates of charge do not rise to the ceiling (Exhibits 6-1 and 6-2).

(2) Even in the cash loan market served by finance companies where the emphasis is on nonprice competition, rates do not always rise to the ceiling (Exhibit 6-3).

(3) If price ceilings are set at or below the market rate, rates will generally be at the ceiling. The precise impact of this upon consumers has yet to be examined.

Do rates rise for other reasons? Commission studies have provided some support for the notion that consumers are not wholly knowledgeable about finance charges and APR's, nor do they appear to shop as intensively for credit as they do for the goods financed. Rates can be higher in some consumer credit markets because ignorance and inertia among borrowers combine with the absence of competition among suppliers. As a result, unequal bargaining power may exist, and the absence of alternative credit sources leads to higher rates or restricted credit availability (or both) in such consumer credit markets. Yet it is well established that perfect knowledge and intensive shopping behavior are not required to make a market workably competitive—for the market to offer opportunities for credit at reasonable rates. What is required is some proportion of consumers who are willing to shift to lower price (rate) sources in a market where credit grantors compete and where new competitors enter easily. As will be seen, the use of rate ceilings to correct instances of unequal bargaining power and an absence of alternative credit sources is largely ineffective. On balance, rate ceilings appear less desirable than policies to make competition workable.

To avoid overburdening consumers with excessive debts.

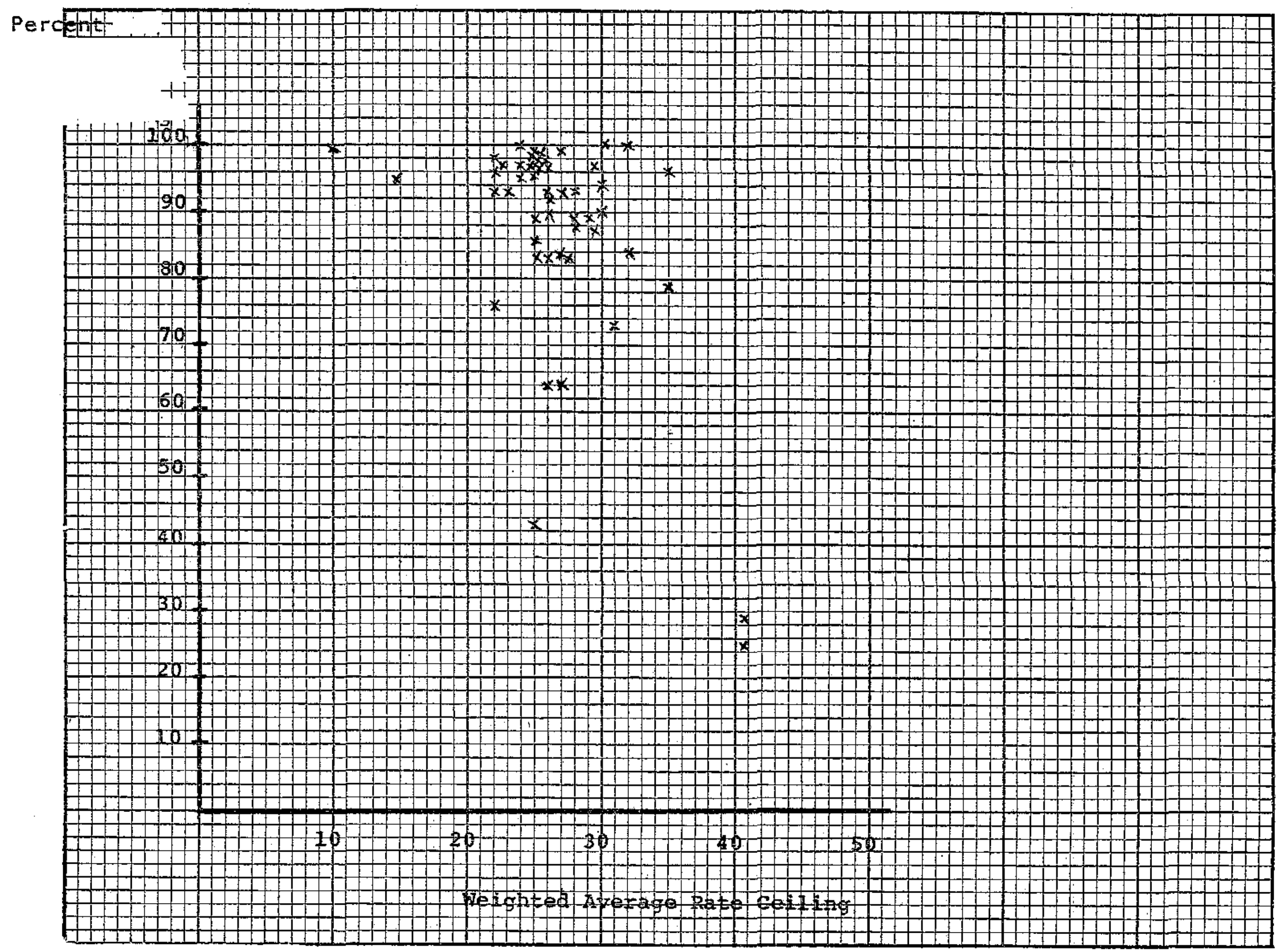
On the theory that consumers cannot estimate how much debt they can carry when acquiring a good or service, some argue for rate ceilings on credit to prevent consumers from becoming overburdened with debts and subject to abusive collection tactics. They contend that credit grantors who are permitted high rates will entrap unwary consumers, overload them with debt, and then use harsh tactics to collect. The theory is sustainable if it can be shown that consumers who would pay rates above ceiling are those who would become overindebted. Generally, it is assumed that they would be. The line of reasoning was well expressed in 1776 by Adam Smith, usually an advocate of a free competitive market:

> The legal rate, it is to be observed, though it ought to be somewhat above, ought not to be much above the lowest market rate. If the legal rate of interest in Great Britain, for example, was fixed so high as eight or ten percent, the great part of the money which was to be lent, would be lent to prodigals and projectors, who alone would be willing to give this high interest. Sober people, who will give for the use of money no more than a part of which they are likely to make by use of it, would not venture into the competition.[50]

What debts are excessive? A discussion turning on excessive use of consumer credit should establish what is meant by "excessive." For some, it means a consumer used credit, possibly at a fairly high APR, to acquire something—a color TV set, or a big car—that the critics consider unwise because of the consumer's economic or

EXHIBIT 6-3

Percentage of APR's Personal Instalment Loans of Finance Companies Equal to or Greater than 90 Percent of the Rate Ceiling by States, Mid-1971



social status. To prevent this "prodigal" from such an unwise decision, a low rate ceiling might force down the permitted APR to the point that he is denied credit. The Commission finds it repugnant to force a denial of credit on many *creditworthy* borrowers by the imposition of another's value system.

Another meaning of "excessive" is simply an accumulation of debt that a consumer is unable to repay in accordance with the terms of his credit agreements. This sensible definition avoids imposing one individual's value system upon another.

Do rate ceilings prevent excessive debt? A basic tenet of our economic system is that most consumers and creditors are rational. Banks and finance companies responding to a Commission survey reported that unemployment and illness were the first and third most important reasons, respectively, for debtors' failures to meet their obligations. At the time they obtained credit these consumers made rational decisions that were later upset by unexpected events. Lowered rate ceilings would not have prevented them from wanting to use credit.

The second most important reason cited was "overextension of credit." This represents an error in judgment by both creditor and consumer; both incorrectly estimated future cash flows to meet the promised payments. Although it is in the self-interest of each party to avoid such errors, they do occur. How does lowering the rate ceiling affect mutual errors of judgment? Governmental lowering of rate ceilings forces lenders offering cash credit to take less risk, narrowing the market they are willing to serve. Consumers are not so constrained; they are even more eager to take on obligations at the lower rate. But because the lender makes the ultimate decision to accept or reject a consumer's promise to pay, he will deny more applications at the lower rates, assume less risk, and limit overextensions of *cash* credit.

Bad debt and collection expenses are significant factors in the total operating expenses of credit grantors, so creditors have every incentive to lend only to those consumers who have the potential ability to repay. Should a credit grantor decide that a 4 percent bad debt loss ratio is the maximum to be tolerated under existing rate ceilings, he will attempt to lend to no higher risk class than the one in which 24 out of 25 credit applicants can be expected to repay. If rate structures are lowered, operating expenses must also be lowered to maintain profitability and if, as a result of lower rate ceilings, a decision is made to reduce the tolerable bad debt loss ratio to a proportion lower than 4 percent the creditor would have to reject more applicants, because every 25th person—unidentifiable at time of application—will not repay. Commission data indicate that finance companies currently reject more than one out of two new credit applicants and one out of three of all credit applicants, including present and former borrowers. Given these rejection rates, the Commission is not prepared to propose any rate ceiling that might be needed to prevent overextension, prefering instead to leave that to the marketplace.

But overextension of cash credit is only a part of the problem. A consumer with less than a prime credit rating who wishes to borrow cash to shop for a TV set may be rejected by all cash lenders because they cannot afford to serve him. But he can still obtain credit at credit retailers if they can merely transfer part of the finance charge into the cash price of the goods and services sold. Even if the ceiling price for credit were set at *zero percent*, consumers could still become overburdened by purchasing goods and services on credit. They do so today from some credit retailers who make no explicit charge for the use of credit. In such situations, a rate ceiling does not prevent consumers from becoming overextended when they are tempted to buy beyond their means. It merely narrows the range of credit sources available and puts the credit retailer in a more powerful bargaining position relative to the consumer who desires credit.

In the third of his classic letters, *In Defence of Usury*, Jeremy Bentham concluded his version of the foregoing analysis by noting:

> As far as prodigality, then, is concerned, I must confess, I cannot see the use of stopping the current of expenditure in this way at the fosset, when there are so many unpreventable ways of letting it run out at the bung-hole.[51]

The potential for harassment of consumers by creditors exists irrespective of levels of rate ceilings. The remedy for harassing collection methods lies not in changing the level of rate ceilings but in effective legislation to inhibit those practices. As Commission hearings in June 1970 brought out, legislation is often adequate but enforcement insufficient.

Furthermore, lowered rate ceilings for the use of cash credit increase the likelihood of unconscionable collection tactics because the high risk consumer must turn to illegal lenders for the cash credit he needs. Such a consumer does not report vicious collection procedures for fear for his life and property and that of his family. If in the cash loan field the aim is to protect consumers from heavy-handed collection efforts, a lowering of the rate ceiling is counterproductive for less affluent, high risk consumers.

The Commission, aware of the importance of protecting those whom Smith described as "prodigals and projectors" from becoming overextended, finds that the placing (or lowering) of rate ceilings on consumer credit does not accomplish that objective. Its recommendations to deal with this problem (Chapter 3) put

emphasis on the need to provide creditors with every incentive to avoid overburdening consumers by limiting creditors' remedies and outlawing harsh collection practices.

To administer credit grantors as public utilities

An alternate purpose of setting rate ceilings on consumer credit transactions would be to assure that consumers are charged rates sufficient to allow creditors to earn a fair return on assets used and useful while providing "adequate" service (however measured) to consumers. This might be termed the public utility approach to rate regulation.

This approach recognizes that if consumers are to be served, rate ceilings must be high enough to permit credit grantors to earn an adequate rate of return on their invested capital. Otherwise, they would shift their resources to some other business. An understanding of the costs of providing consumer credit as discussed in Chapter 7 is important in assessing whether or not rates are "too high;" but to employ a public utility approach to the setting of price ceilings on the use of credit involves much more than a mere understanding of costs.

Most regulation of public utilities limits the prices that may be charged by a firm to which some governmental body has granted a franchise. Usually, public utilities are monopolies. For example, a city or state will grant a franchise to only one electric power or telephone company. Such firms are not complete monopolies, of course, since there are alternative sources of power and communication. But credit grantors are not granted franchises. They generally compete with one another more vigorously than most public utilities. Each city typically has a number of banks, credit unions, finance companies, and retailers offering consumer credit. In addition, a consumer may be able to obtain a loan by mail, borrow on his life insurance policy, or use one or more credit cards. In contrast, a consumer wishing to light his home has no realistic alternative to using electricity and only one source of electric power.

There is a basic theoretical problem in treating credit grantors as public utilities. If a rate commission permitted credit grantors to earn some given percentage return on "assets used and useful,"[52] each credit grantor could select whatever risk class of customer he wished to serve. Over time the costs of providing credit to that risk class would require the rate commission to approve credit prices sufficient to cover those costs and earn the prescribed return. In effect, the price ceiling for each creditor would be set on a "cost-plus" basis and would be a self-fulfilling result of the risk class served.

To avoid setting price ceilings for consumer credit on a cost-plus basis under such a public utility approach, a rate commission would have to specify in some manner the highest risk class of consumers that could and *should* be served by each credit grantor. Unless the rate commission were then prepared to examine the validity of credit turndowns for each franchisee, credit grantors operating under a fixed rate ceiling could improve their profit margin by denying credit to riskier consumers and by not offering costly forms of credit, such as small, short-term loans. The establishment of credit standards and appropriate prices for multifaceted credit arrangements and the enforcement of requirements that credit grantors meet any "justified" demands by consumers of widely varying credit standings pose dire problems for a rate-making commission governing franchised consumer credit grantors.

There are practical difficulties to treating credit grantors as public utilities, too. First, there are severe problems involved in cost measurement, particularly among commercial banks, many finance companies, and retailers. Most credit grantors offer a variety of consumer credit agreements, and many engage in other activities as well. Because of the problems of joint costs, it would be extremely difficult and expensive to allocate costs and revenues among the various activities and types of credit of credit grantors. Second, in the case of sales credit it would be difficult for a rate commission to determine whether or not a credit seller was evading the specified price ceilings on the credit service by reducing quality of his goods and services or by inflating their cash prices. Finally, if each of the thousands of grantors of consumer credit were subjected to the same scrutiny as each gas and electric company, telephone company, and every other public utility, the Nation's law and business schools would not be able to supply the requisite numbers of attorneys and accountants to do the job.

It should be added that an error either in theory or in application of public utility regulation to consumer credit grantors would have a much more immediate effect upon users of credit than upon consumers dependent upon present-day utilities. An electric power company has a large investment in fixed assets and will continue to supply electricity for many years even though the rates granted are inadequate. So long as revenues cover marginal costs, it will stay in business until it becomes necessary to replace plant and equipment. In contrast, the assets of most credit grantors are highly mobile. If a commission provided inadequate rates, prospective credit grantors would not enter the state and those operating in that market might leave or severely curtail their activities. This was the history in New York between 1941 and 1967 when the legislature and Banking Department attempted to adopt a public utility approach to setting rate ceilings for

licensed lenders. Since the Department selected a permitted return on "assets used and useful" that was significantly below the rate necessary to attract capital into the industry, the consumer finance industry languished during the period.[53] History provides at least three cases where states have pushed rate ceilings on loans by licensed lenders so low that legal lenders were forced from business.[54]

Thus, the evidence shows that the public utility approach to the regulation of consumer credit grantors is theoretically neither sound nor feasible.

To assure that consumers pay fair rates for credit

The most compelling problem to be considered is whether rate ceilings assure that consumers pay "fair" rates for credit. The crucial questions deal with whether rates are fair for some, for all, and for whom if not for all. Additionally, there is an immediate problem in judging the fairness of rates without judging the associated terms under which credit is granted. This package—the credit offer function—is complex with features having differing values to different consumers. These features should properly be taken into account in determining if a consumer is paying a fair rate. Finally, there exists no generally acceptable standard for what is a fair rate.[55] Notwithstanding this complexity, it is possible to consider the impact of rate ceilings in terms of a two-dimensional credit offer function: rate and risk. The underlying assumption, of course, is that consumers who pose a high risk to the credit grantor must pay higher rates, other things being equal. Although the following analysis is set in terms of this two-dimensional credit function, it is equally applicable to the actual multidimensional function.

Cash credit. About 30 percent of outstanding consumer instalment credit originated as personal cash loans and another 10 percent as direct automobile loans by commercial banks. In the analysis of the effect of rate ceilings in this field it is assumed that the ceilings cannot be evaded and are enforced.[56] As pointed out in Chapter 5 on credit insurance, the finance charge earned by credit grantors should be sufficient to support the credit service, and charges for credit insurance should be at a level sufficient to support the insurance service—each service should be economically independent of the other. Thus it is assumed here that a decreed reduction in rate ceilings on credit cannot and should not be offset by increased income from some other credit related source such as credit insurance premiums.

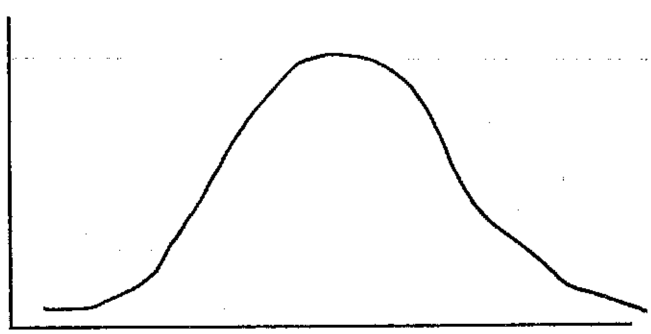
Consumers present different levels of risk to a potential credit grantor. The creditworthiness of consumers is often measured by application of credit-scoring techniques, and the resulting distribution of credit scores—credit risk—typically looks like diagram A. A large proportion of consumers is grouped within a middle range of risk, but there are significant numbers who pose a considerable hazard to a potential creditor. Many potential borrowers who are creditworthy may not use consumer credit because they can draw on savings to meet their needs.

It becomes progressively more costly for lenders to serve consumers who present an increasing hazard of credit loss. Not only do bad debt losses rise but the cost of collection efforts also grows. Consequently, rates in a competitive market without rate ceilings should rise as credit is provided to consumers of higher and higher risk.

What are the effects of imposing price (rate) ceilings upon cash credit, first in a competitive market and then in an imperfect market? The impact may be examined with the aid of diagram B. The curve represents the cumulative numbers of consumers in progressively higher risk classes. Put another way, it is a cumulative distribution of the bell-shaped curve shown above,

Diagram A

Number
of
Consumers



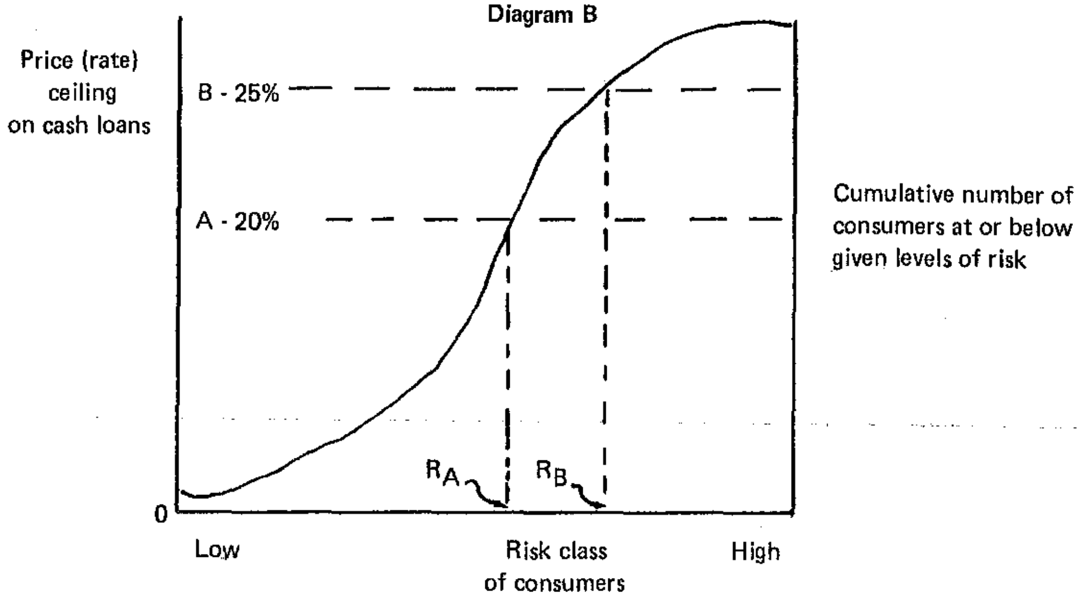
Low

High

Risk class of consumers

496-072 O - 73 - 9

Diagram B



adding successively more risky consumers from left (low risk) to right (high risk).

In a perfectly competitive market without any price ceiling, consumers in the risk class shown in the diagram at point R_B would pay 25 percent and those at the point R_A would pay 20 percent. If a price ceiling of 20 percent were imposed, it would be fair only for the consumers at the point R_A. But it would be too low for any risks higher than R_A risks. Given the higher collection costs and bad debt losses that would be incurred by serving those customers posing higher than R_A risks, no consumers above the point R_A could be served by legal lenders. They must be rejected and must either postpone their use of cash credit, seek credit from sales creditors (where a portion of the finance charge may be incorporated in the cash price of the goods), or turn to illegal lenders. The 20 percent ceiling rate would be above the fair rate for borrowers of better quality than Class A—that is, those to the left of R_A. Under a competitive situation these consumers would pay the rates that they deserve, whether a price ceiling was present or not. Thus, under competitive conditions the imposition of the price ceiling would be injurious to consumers above Class A and superfluous for those in Class A and better.

In contrast, assume that the market for cash loans is imperfectly competitive. Cash lenders appear to exercise strong market power in some states. Further, there is evidence that not all consumers shop carefully for their credit and compare rates of charge on the basis of information provided by TIL. Does the imposition of a 20 percent rate ceiling on cash credit provide significant protection to these same classes of consumers by assuring that they pay a fair price for their credit? The position of the consumers above point R_A is unchanged; they are rejected because legal lenders have no incentive to provide unprofitable credit at the decreed rates.[57] Class A consumers, as well as consumers whose risk is less, may be helped if, in the absence of the rate ceiling, they would otherwise pay as much or more than 20 percent to obtain cash loans. If they fail to shop wisely for credit, for example, they may pay more than 20 percent—quite possibly much more than they should pay, given their risk class. Thus, rate ceilings may allow some better credit risks to pay less in imperfectly competitive markets, but only at the expense of the higher risk borrowers who are excluded from the market. As noted before, rate ceilings may cause a transfer of credit costs to cash price in sales credit.

It would be fallacious to assume that higher risk consumers thus denied legal cash loans would forego their desired credit-financed consumption. Some will turn to sales credit where some portion of the finance charge may be buried in the cash price of the good or service. Others may turn to the illegal loan market. Their fate was graphically described to the House Subcommittee on Consumer Affairs by Professor John Seidl:

> Criminal loan sharking contains three necessary characteristics in my opinion. First of all is the lending of cash at very high interest rates by individuals who are reputed to be connected with the underworld. . . . The second characteristic is a borrower-lender agreement resting upon the borrower's willingness to pledge his and his family's physical well-being for the proceeds of the loan . . . . Third is the belief by the borrower that the lender has connections with ruthless criminal organizations. . . . Twenty percent continues to be an

important element in the small-loan charge today. The rate in some urban areas for small loans is 20 percent per week . . . 1,040 percent per annum . . . . In other urban areas, the rate is 20 percent for a 6- or 10-week period with interest charges added to the principal and the total repaid in weekly installments . . . . Twenty percent add-on for a 6- to 10-week period produces from approximately 200 to 350 percent per annum.[58]

The difficulty is that most consumers forced from the legal cash loan market into the hands of loan sharks are represented in no statistical sample, pay rates that are unreported and undisclosed, and must remain mute when legislatures lower price ceilings on consumer credit in well-intended efforts to afford greater "protection" to some other borrowers. Without presuming to pass on constitutional issues, the Commission must at least raise the question of whether it is desirable for the state to deprive one group of consumers access to cash credit by rate ceilings while permitting more affluent consumers to obtain cash credit.

Sales credit. The remaining 60 percent of outstanding consumer instalment credit is in the form of sales credit—credit granted in conjunction with the credit sale of consumer goods and services. If these markets are perfectly competitive, each consumer would presumably pay the rate appropriate for his risk class. In a less-than-perfect market, not even consumers who deserve just the ceiling rate are assured of paying a "fair" price because of an option not available to cash lenders. If a cash lender is denied a rate above, say, 20 percent, he cannot serve consumers deserving to pay rates higher than 20 percent because he cannot enhance his combined income from credit and credit insurance. In sharp contrast, a credit retailer operating in an imperfect market and denied the opportunity to charge more than 20 percent directly may earn a higher rate indirectly to the extent that he can exercise his option to raise the cash prices of the goods he sells.

Clear evidence that low income retailers raise the price of goods to finance higher risk customers is provided in the Federal Trade Commission's 1968 study of the credit and sales practices of retailers in the District of Columbia where little or no cash credit existed in low income areas. Although the average of APR's charged by low income retailers was about 4 percentage points higher than the rates of general market retailers to finance a sewing machine with a common wholesale price of $100, the average cash retail price of the low income retailer was $297 compared with average cash prices of only $196 at appliance stores and $174 at department stores.[59] Differences in cash prices of $101 to $123 obviously greatly outweigh the small variances in the dollar amount of the finance charges. (In spite of their much higher cash prices, retailers in the low income market generally reported lower average returns on their net worth than did general market retailers.)[60] The time price charged in the low income market may or may not be justified. But if only a portion of that time price—the finance charge or time-price differential—had been limited to a rate below the rate charged, there still would have been no effective cap on the *total* time price which combines both the finance charge and the cash price.

Because of the possibility of transferring all or some of the finance charge into the cash price in imperfect markets, the only effective means of protecting consumers in the kind of market surveyed by the FTC is to introduce more competitive alternatives, especially in the form of cash credit. A fairly significant portion of the power of the inner city retailer to raise his "cash" price stems from the lack of convenient availability of cash credit. Because no small loan offices operate in the District of Columbia, low income consumers must travel to Maryland or Virginia if they wish to borrow from legal lenders, or are forced to buy from credit retailers where they have little choice but to pay significantly higher time prices than available to other consumers who can get cash credit.

Forcing rates on sales credit below market rates has two consequences:

1) Reductions in availability—In recent years there has been considerable pressure to force down the ceiling prices of sales credit, particularly revolving credit—both retail and bank credit card. Were extreme rate reductions forced on cash credit, the effects would be seen immediately: cash credit would become unavailable—just as small loans are for low income consumers in the District of Columbia. But the effect on consumers of a forced reduction in the price of sales credit is more subtle and complex although the unfavorable impact may be no less than that caused by a corresponding reduction in rate ceilings on cash credit.

Forced reduction in the decreed maximum rate on revolving credit to 10 percent per annum (as in Arkansas) or from 1½ percent to 1 percent per month (as in Minnesota, Wisconsin,* and Washington) have a twofold effect on consumers. First, credit sellers may make less credit available for the same reasons discussed in the section on cash credit. Or, second, they may try to make up the loss in income from some other source. As Professor William C. Dunkelberg of Stanford University concluded in a research report prepared for the Commission:

> The total volume of credit extended by firms will likely fall; certainly, less credit (or at best, no more)

*Legislatively raised to 1½ percent per month effective March 1973.

will be available at a lower rate such as 12%. The incidence of this reduction in availability will not be random in the population of consumers, but will fall primarily on low income or otherwise disadvantaged consumers.[61]

By applying the credit-scoring systems used by a large bankcard service to families included in the representative sample of U.S. families covered in the 1967 Survey of Consumer Finances,[62] Dunkelberg could identify those families who would be denied credit if the lowered returns from providing credit forced an increase in the minimum score necessary to obtain credit:

> If 20 were the minimum score, raising the minimum to 25 would eliminate 556 families that qualified on a 20 point criteria. Over 70% of those eliminated would have a family income of under $5,000 per year. Over 90% would have incomes below $7,500 per year. Thus, the incidence of the rationing would fall heavily on the lower income families. It is these families that have the fewest financial options and for many of these families, credit buying would become an impossibility or would be available only at much higher rates . . .[63]

2) Forced subsidy—A second effect of forcing rates on sales credit below the level that would be set by the market may involve the forced transfer of a portion of the finance charge into the cash prices of goods and services. At the outset it should be recognized that retailing is a highly competitive business, largely because entry and exit are relatively easy and frequent. Some assessment of the degree of competition is provided by a comparison of net profits after Federal income taxes as a percentage of stockholders' equity in 1969 for manufacturing firms and retailers:[64]

	Percent
All manufacturing	11.5
Total durable	11.4
Motor vehicles	12.6
Primary iron and steel	7.6
Lumber and wood products	13.0
Total nondurable	11.5
Food and kindred products	7.9
Chemicals and allied products	12.8
Leather and leather products	9.3
Department stores (by sales volume in millions)	
$1 - $2	2.73
$2 - $5	7.73
$5 - $10	4.85
$10 - $20	6.19
$20 - $50	5.81
Over $50	7.74
All department stores	7.31

Whether or not it is desirable to legislate low rate ceilings to gain further reductions in the rates that may be charged for sales credit is basically a matter of social policy. The question has been asked, "Should retailers make money on finance charges as well as on goods?"[65] But the question avoids the issue. Retailers must make a profit on their *total* sales of goods and services (including credit services) to remain in business. There are substantial costs in providing credit, and the low level of retail profits provides no evidence of any monopoly control over the market. So, the only real issue is who should bear these credit costs—credit buyers or cash buyers. Somebody must bear them.

The Commission's econometric studies of sale credit are summarized in Chapter 7; but the problem which arose in those studies in explaining the relationship between rate ceilings and availability was the lack of a variable to measure differences in the prices of goods sold on credit. Other studies, however, have obtained data and provided evidence to support the hypothesis that price and other adjustments occur if credit is to be continually made available. In 1968, for example, Gene C. Lynch found that prices paid in Little Rock, Arkansas were higher than those paid in cities in other states for a group of identical appliances. Forming an index with a base price set at $100 for Little Rock, comparable prices in the neighbor-state cities were found to be:[66]

	Color Television	Washer & Dryer	Refrigerator	Range
Little Rock	$100.00	$100.00	$100.00	$100.00
Texarkana, Texas	94.26	95.94	96.83	99.34
Monroe, La.	96.47	98.15	95.99	94.48
Greenville, Miss.	97.18	96.30	97.35	93.64
Springfield, Mo.	96.95	99.64	97.07	93.14

It can be argued that a forced reduction in the price of revolving credit is desirable if credit buyers are paying excessive rates in relation to the costs of providing credit. Consumers using credit to acquire goods are likely to be less sensitive to the price of credit than to the much larger cash price of the item purchased. Yet an examination of the costs of providing credit at retail stores suggests that, even at a typical charge of 1½ percent on monthly unpaid balances, the gross finance charge does not cover the full economic costs of providing the service. This point was made in hearings on the Consumer Credit Protection Act by Joseph W. Barr, Under Secretary of the Treasury, in response to a question from Congressman Lawrence G. Williams:[67]

> MR. WILLIAMS. From your familiarity with credit transactions is there any additional expense connected with these revolving accounts that could conceivably justify an 18-percent annual interest rate?
>
> MR. BARR. I don't believe that is an exorbitant rate. These are frequently small accounts and I am not saying that revolving credit is a bad thing. I think it is a great thing. It is the charge account principle that was once limited to a few affluent people and has now moved across the whole economy. But when you have millions of small credit transactions—with bookkeeping charges and credit examinations and other costs—I doubt that you can make money at much less than 18 percent.

One set of data may be cited to demonstrate the cost-price relationships. In a survey of 15 stores with annual revolving credit sales of over $402 million, Touche, Ross, Bailey and Smart found that revenues from finance charges amounted to 6.08 percent of sales and costs of providing the service amounted to 8.39 percent of sales, leaving a deficiency of 2.31 percent.[68] So, even before the recent cuts in the permissible maximum revolving credit rates in several states, cash buyers seemed to be subsidizing credit buyers.

There is no logical reason to select any type of product or service sold by a retailer and legally require it to be sold at a loss. When credit is selected as the required loss leader, the burden of subsidy falls primarily on cash buyers, some of whom may have been unable to obtain credit. Thus state laws that put the price of credit below competitive rates are forcing both the wealthy and the less affluent, who do not use or cannot obtain credit, to subsidize the use of credit by others. Such laws also tend to discourage those who can obtain credit from using cash to buy goods. In the Commission's view, lowering rate ceilings on revolving credit below 1½ percent per month has on balance been contrary to the best interests of consumers. Indeed, in view of documented costs of providing credit, it appears that the required reduction in finance charges has forced some retailers into a position approaching deceptive merchandising. As shown in Chapter 10, the Commission is concerned with offers of "free" credit when, in fact, the cost of the credit service is buried in the cash price of goods sold on credit. Consistency requires no less concern when laws, in effect, force a transfer of some part of the price of the credit service into the cash prices of goods and services.

Regardless of the costs of providing any form of sales credit, a reduction by legislative fiat of the permitted gross income from finance charges necessitates adjustments in goods prices, fees, or availability. If not, lowered profits will force some retailers—probably small ones—out of business. While credit sellers may recover part of their lost income by reducing other services or adding fees for services previously furnished without charge, the most likely offset is an increase in cash prices resulting in a subsidy of credit by cash purchasers.

Related Issues Affecting Rates

At times legislatures pass laws that seem to affect only the methods of assessing finance charges but in fact actually change the rate ceilings. For example, a *requirement* that credit grantors offer consumers a 30-day "free period" on all revolving credit would really be a reduction in rates for banks that offer revolving *cash* credit because they do not typically offer such a free period. If there is a valid economic reason for prohibiting a charge for the first 30 days of a credit transaction, it has escaped Commission attention. But if such a "free" period is deemed a "fair" or desirable policy, it should be remembered that the impact of the change will reduce the rate ceiling APR and that the probable effect on cash and sales credit will take the form described in preceding sections.

Another issue is whether or not credit grantors should be permitted a minimum charge for extending credit—such as the initial charge on a taxi meter regardless of the length of the journey. Some may view it desirable to eliminate such charges, but the effect on extensions of small amounts of credit again will be as previously outlined. Cash lenders will find it unprofitable to make small loans (just as cab drivers denied an initial charge find it unprofitable to make short trips) and those offering sales credit will reduce the availability of small credit sales and attempt to recover lost income in higher cash prices. Some consumers may gain, others will lose. There is no convincing evidence that on balance consumers will be better off. If the premise is granted that it is only fair for creditors as a group to recover the costs of providing credit, the same reasoning should apply to the granting of small versus large amounts of credit. Minimum charges are to cover costs

associated with the credit function regardless of the size of the balance. That line of argument would support minimum charges, both as a matter of equity and as a deterrent to the uneconomical use of credit.

Another much-debated problem is how those offering revolving credit should be permitted to assess their monthly finance charges. One aspect of the issue is to identify a system that is fair to consumers. But the selection of a particular system as a matter of law also effectively raises or lowers the rate ceiling.

With regard to the issue of fairness to consumers, the Commission believes, first, that firms providing revolving credit should deduct any credits for returns and allowances *before* determining the periodic balance to which the periodic rate is applied. A consumer who has had to return merchandise bought on credit has evidently received little or no benefit from its use and should not be asked to pay a finance charge on its initial unpaid balance. Second, charges for purchases and credits for payments should at least be treated symmetrically within a billing period. Specifically, no finance charge should be made for a purchase within a billing period unless credit is also given for any payments received within the same period. Third, within these guidelines it is important to leave open as many reasonable options as possible. Were all retailers forced to levy charges on the basis of the average daily balance, for example, most small retailers would be unable to assume the expense of compliance and would be forced to adopt bank credit cards. Such a result would not only be noncompetitive but would also reduce consumer options.

CONCLUSION

On the basis of a summary of the historical approach to the establishment of rate ceilings and institutional knowledge about them the Commission must conclude that, on balance, rate ceilings are undesirable when markets are reasonably competitive. Imposition of rate ceilings on consumer credit transactions neither assures that most consumers will pay a fair price for the use of credit nor prevents overburdening them with excessive debt. The public utility approach to rate making in the field of consumer credit is neither theoretically sound nor feasible although it can serve as a reminder that legislators must recognize the relationship between costs and credit sizes if they do set rate ceilings.

The Commission did determine that current knowledge about the effect of rate ceilings on the price and availability of consumer credit was not sufficiently precise to be used as a basis for recommendations regarding rate ceilings. For this reason, the Commission undertook its own technical studies based on empirical evidence collected in the marketplace and presents its findings in Chapter 7. Before this research was undertaken by the Commission, there were no national estimates of rates of charge for various types of consumer credit nor detailed estimates of amounts of consumer credit extended or outstanding on a state or regional basis. Lack of state-by-state estimates of consumer credit had prevented research scholars and others from making thorough studies and analyses of the effects of differences in state laws—including rate ceilings—and other factors on the availability of consumer credit and rates of charge for it. Nor had it been possible to study the effectiveness of competition among states, because any evaluation of market performance requires knowledge of the level of prices and quantities of output. The Commission staff collected the data necessary to make these analyses and comparisons, and Chapter 7 discusses the implications of these data.

Chapter 7

RATES AND AVAILABILITY OF CREDIT

(Editor's note: Material in this chapter is highly technical and utilizes concepts and language from the discipline of economics.)

ISSUES, THEORY, AND OVERVIEW

From the preceding review of interest rate ceilings—on historical, institutional, and legalistic bases—two principal findings emerged: (1) Although social control of the credit industry by means of rate ceilings may seem morally, ethically, or paternalistically laudable, a policy aimed at obtaining and maintaining competition was found preferable. (2) Where legal rate ceilings have been imposed, they affect average market rates of charge only in a few credit markets. In practice they appear to be largely superfluous. Further, they may generate a false sense of security that social policy governing the industry is adequate for the public interest.

No recommendations were made on the basis of these findings because policy formulation, including rate ceiling policy, greatly depends upon answers to two further fundamental questions:

1. If legal rate ceilings do not appreciably affect or determine observed average rates of charge in most credit markets (by state and type of credit), then what factors actually do determine observed average rates and, in particular, what is the role of competition in the determination of rates?
2. What is the relationship between observed rates—whether legally determined or "market" determined—and the availability of consumer credit?

The first question is important—and remains unanswered despite the analysis of Chapter 6—because the observation of market rates below ceiling rates does *not* necessarily imply the existence of workable competition in the marketplace. If competition is inadequate, corrective policy changes are required—the basic policy options being lower rate ceilings or encouragement of greater competition. The second question is important because its answer will point to which of these options is preferable or what mixture of them should be developed if competition is found to be inadequate. Availability and market rate are so related that legally determined rates may adversely affect availability and that of course would constrict the use of rate ceilings as a policy tool benefiting all consumers.

The following brief, summarized answers to the questions on "rate" and "availability" draw heavily from simplified economic theory and the exhibits of the preceding chapter. Basically, what is required is an understanding of probable relationships between market price, legal price, and availability under two alternative competitive conditions—"intense competition" and "imperfect competition." Empirical evidence from staff studies (to be examined later) confirms the validity of hypotheses based on economic theory reviewed here.

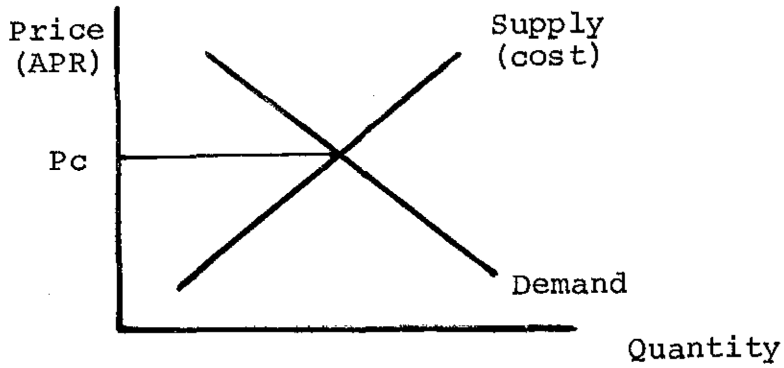
Intense Competition

A highly competitive market exists when the number of sellers is so large and entry is so easy that no seller has power over price (in this study, annual percentage rate). Price is determined by the interacting forces of supply and demand. In Figure 1 this is shown by the intersection of supply (a positive function of price because costs, particularly risk costs, rise with increased quantities supplied) and demand (a negative function of price because greater quantities are demanded as price falls). The market price, Pc, is the only price for which supply and demand are equal. Under these conditions the relationships between rate ceilings, market price, and quantities supplied and demanded (availability) can be easily outlined.

A1. If the price ceiling is above the competitive market rate (Pc in Figure 1), the ceiling will affect neither the observed market price nor the amount supplied, because the interactions of supply and demand are operative.

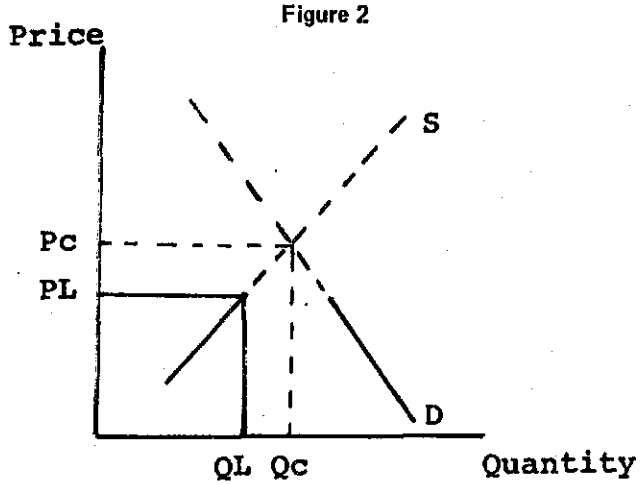
A2. If the price ceiling is below the market rate (Pc in Figure 1), the rate ceiling will determine the observed market rate and the quantity supplied will fall as the rate ceiling falls. This is shown in Figure 2 where P_L is below Pc, and Q_L is the amount supplied under the imposed lower price. There is excess, unsatisfied demand because the cost factors of the supply curve dominate. So long as

Figure 1



the rate ceiling is above Pc, the legal price rises or falls without affecting the market price. On the other hand, when the legal price is below Pc, it directly lowers the amount supplied. This is shown in Figure 2 by comparing the quantity QL with Qc. The effect is more diffuse when legal rate ceilings are set below the market rate charged for credit by a seller of goods. Although that somewhat restricts the supply of credit, some portion of the finance charge may be driven into the cash prices of goods and services sold on credit.

Figure 2



Imperfect Competition

B. When a few firms possess market power in a particular market, they may charge higher than competitive market prices if it is more profitable for them to do so. With this condition, price could be as high as, say, Pm in Figure 3, which can be called the monopoly price. Monopolies do not raise price indefinitely; there is some optimum beyond which they will not go. For varying degrees of market power which are less than monopoly, the market price will vary between Pm and Pc. To the extent that market power declines, thereby increasing availability and reducing price towards Pc, the market may be described as being "workably competitive." Here relationships between legal rate ceiling, market price, and supply (availability) can be outlined as follows:

B1. If the rate ceiling is above the market price, Pm, it will affect neither the market price nor supply. Variations in market price attributable to differences prevailing in market power will be negatively associated with the quantity of credit extended because demand "dominates" in the price range between Pc (competitive) and Pm (monopoly).

B2. As the legal rate ceiling falls, it will begin to impinge on the market rate and determine amounts of credit offered. This is shown in figure 4. In the range from Pm to Pc, the amount of credit supplied will rise as the price (which equals market price) falls because of demand side dominance. But as the ceiling continues to fall below Pc, say down to P3, the amount of credit supplied falls just as it did for the purely competitive case in paragraph A2 because supply (cost) factors then dominate. To repeat, some portion of the finance charges on sales credit will be buried in the cash prices of goods and services sold on credit.

The resulting relationship between the legal ceiling and quantity is depicted in Figure 5. Above the level at which market power would set the observed rate, Pm,

Figure 3

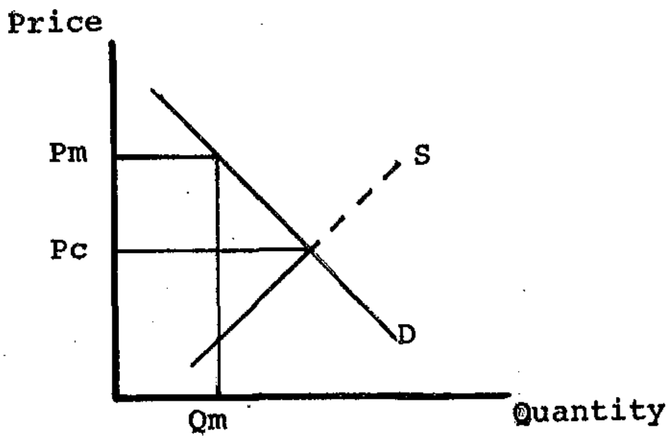


Figure 4

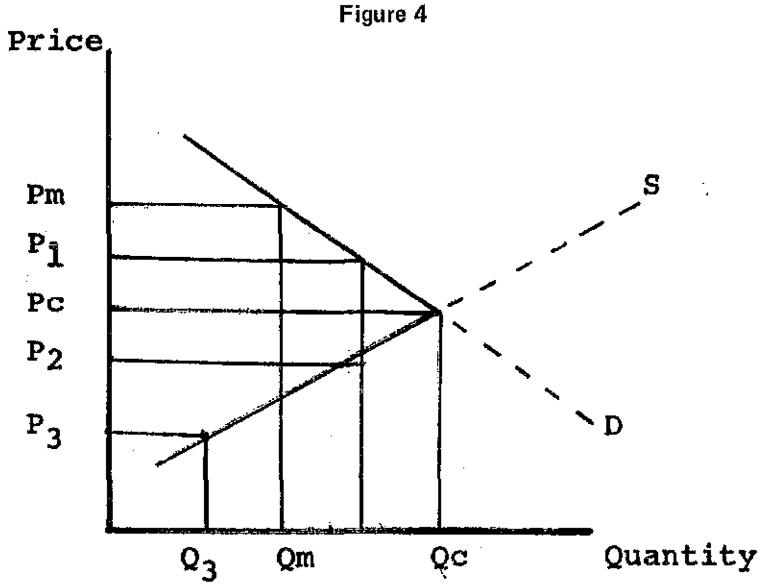
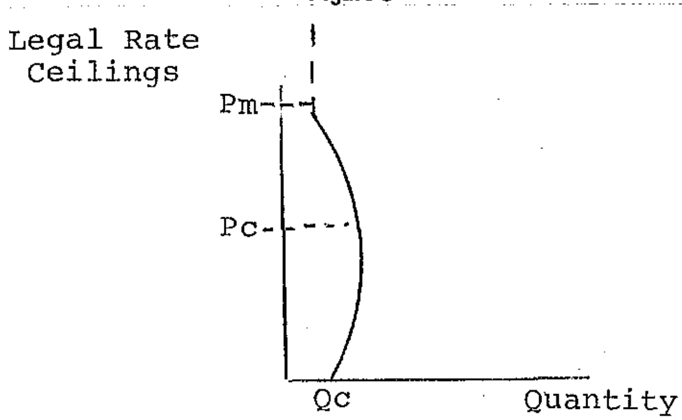


Figure 5



the ceiling has no relationship with supply. As the ceiling falls, it first increases supply (in the Pm to Pc range) and then causes it to fall.

In light of these theoretical considerations, it is possible to provide *theoretical* answers to the "rate" and "availability" questions. First, if state legal rate ceilings are not low enough to affect appreciably the observed rates of charge, such factors as the intensity of competition, the level of production costs, and the strength of demand will determine the market rate. Second, when a relatively low legal rate ceiling does determine the observed market rate, it also affects credit availability (a lowering of the ceiling typically curtails the amount supplied). Third, lowered ceilings on sales credit may force cash buyers to subsidize credit buyers to some extent.

An empirical validation of these answers is a difficult and complex task. The staff of the Commission could not, for instance, trace these relationships through time for a particular type of credit in any local or state market because no single market experienced sufficient changes in conditions for such a test. However, since relevant conditions do vary across states, the staff could conduct a cross-section econometric analysis using mid-1971 data from the Commission's survey of the industry together with data from other sources, particularly the 1970 Census of Population. That analysis led to the following simplified summary of conclusions:

a) The analysis of state markets for *new automobile credit* discloses a situation consistent with the description of paragraph B1 depending on the state. In all but a few states, rate ceilings are inconsequential as a determinant of the market rate (see Exhibit 6-1, Chapter 6). Also, observed quantities of credit extended vary inversely with market power (measured by market concentration).

b) *Retail revolving charge account credit* is typified by the descriptions of A1 and A2. Apparently competition in general merchandise retailing is sufficiently "workable" to prevent large variations in price or supply which could be explained by a lack of competition. In approximately 11 states, rate ceilings for this type of credit are relatively low, with results such as outlined in A2. The remaining states seem to fit the A1 description.

c) *Other consumer goods instalment credit* market conditions vary. Behavior governing direct OCG instalment credit from financial institutions appears to be explained by B1, as in the case of new auto credit. Retailer behavior for this type of credit is also best explained, in general, by the B1 description, though in some states B2 might be more appropriate because ceilings are partially operative.

d) Legal interest rate ceilings have their greatest impact in state markets for personal loans (Exhibits 6-2 and 6-3, Chapter 6). Competition in many of these state markets is sufficiently constrained, often by rate ceilings, to permit the application of descriptions B1 and B2.

In sum, the empirical answers to the "rate" and "availability" questions are generally consistent with the theoretical answers. Competitive conditions are a major determinant of rates and availability in the many state markets in which legal ceilings are sufficiently high to leave the market rate unaffected. This finding does not argue for the imposition of lower rate ceilings, however, because rate ceilings cannot be adjusted as precisely as required if adverse effects on availability are to be avoided. Empirical evidence indicates that rate ceilings that impinge on market rates are also associated with substantial reductions in credit supply.

These empirical findings are next reviewed in greater detail for each of the major types of consumer credit—new auto credit, other consumer goods credit, and personal loans. Specific recommendations for policies designed to improve competition are then presented. Aware that workable competition will not be achieved in the near future in all states, the Commission makes temporary recommendations concerning legal rate ceiling policies that it feels are appropriate until competitive conditions become satisfactory. Since these recommendations are in large part grounded on cost considerations, a discussion of costs precedes the recommendations.

FACTORS INVOLVED IN DETERMINING RATES OF CHARGE AND THE AVAILABILITY OF CREDIT

Credit availability can be defined conceptually as the degree to which creditors are willing to provide credit at the free market rate in a world without imperfections. Although this ideal market is still far from reality, the definition can be used to assess the *relative* availability of credit under the imperfect market conditions that deviate from the ideal. This section outlines the factors involved in determining the availability of credit in competitive and in imperfect markets.

Availability in a Competitive Market

In an ideally competitive market, rates reach competitive equilibrium levels through a series of adjustments by suppliers of various credit offers to various risk classes of consumers.[1] These rates are high enough to cover costs and enable creditors to earn a normal return on invested capital. Creditors are willing to extend any amount of credit to qualified borrowers at such rates,

and the situation can be characterized as one of full availability.

Economic forces affecting availability of credit differ from those that determine, say, the availability of men's shirts. A retailer who sets a price of $7.50 per shirt is willling to sell shirts to all customers at that price. In contrast, a finance company that sets a rate of 18 percent for a 24-month unsecured loan for $1,500 is *not* willing to serve all applicants at that price. The lender envisions a certain minimum credit standing to be met, and will reject as many as two out of three new applicants willing to borrow at that rate.

Even in a workably competitive market, credit grantors find it uneconomical to adjust the price of credit precisely to variations in operating costs resulting from differences in the terms of the contract and in perceived risk. A retailer may levy a flat 50-cent delivery charge within a metropolitan area, regardless of the distance traveled or the size and weight of the package. A finer discrimination in delivery charges might cost more than the greater revenue (or equity) achieved. Similarly, credit grantors often "pre-package" credit offers and in pricing the packages ignore some variations in the costs. A finance company may offer 30 and 36-month new car contracts but not 32-month contracts; and the APR may be the same on both the 30 and 36-month contract, despite possible differences in costs.

Under imperfectly competitive conditions, many credit grantors set a "house rate" for potential customers and accept all consumers sufficiently creditworthy to meet the house rate. A bank with an APR of 12 percent on all 30 and 36-month direct new car loans may accept all customers whose risk class deserves that or a lower rate and reject those in a higher risk class. Under *perfectly* competitive conditions, a creditor would have to give a rate consistent with the customer's risk or lose the business to another creditor who would. At present, a very good customer may negotiate a lower rate single-payment loan or even a lower rate on an instalment loan.

Aside from the expense of providing a variable rate structure attuned to cost and risk, creditors now hesitate to make adjustments because of difficulties in explaining why one customer must pay a higher rate than a friend who gets credit at the same source. Also, until the fairly recent development of credit-scoring systems, creditors had little scientific justification for varying rates according to perceived risk. Such systems are still not used by all credit grantors and so cannot yet be relied upon to determine a variable rate structure based on perceived risks among all classes of borrowers.

Because of the tendency to establish a "house rate" in the consumer credit field, even in workably competitive markets consumers are likely to find a wider variation in rates—and availability—among different *types* of credit grantors than among firms of the same type. The range of rates on personal loans is greater across industry lines among credit unions, banks, and finance companies than it is among credit unions alone. Put another way, high risk consumers are likely to find credit more available at finance companies at higher rates than at credit unions and banks at lower rates, but will probably not find great differences in availability among finance companies. This tends to segment the market somewhat despite considerable overlapping of rates and a great deal of interindustry competition on other aspects of the credit agreement.

Factors that Restrict Availability

In general, any kind of market imperfection—any restriction which tends to inhibit the free interactions of potential borrowers and suppliers of credit—can have a potential effect on credit availability. Such market imperfections include legal constraints, regardless of intent, as well as noncompetitive behavior of suppliers. Legal factors of most potential significance are rate ceilings, restrictions on other credit terms such as loan size and maturity, limitations on creditors' remedies, and legal constraints on the entry of new firms.

The restrictive effect on availability can occur in two basic forms: a price effect and a nonprice rationing effect. In the first case, which arises from noncompetitive behavior of credit grantors, credit prices are set above the free market rate that would otherwise occur and result in a level of credit extensions lower than the free market level. Nonprice rationing occurs when credit terms, such as loan size and maturity, are made too restrictive for potential credit users or when credit suppliers refuse to serve some qualified credit applicants. The various causal relationships fall into five groups.

Legal rate ceilings. The effect of restrictive rate ceilings is to limit the number of borrowers who qualify for legal credit and reduce the amount of credit supplied (Chapter 6). In some instances a restrictive rate ceiling may also lead to an increase in market concentration. If less efficient suppliers are forced out of the market because they cannot compete at the restricted price, the remaining firms will then control a larger share of the market. Then if the degree of market concentration is sufficient to induce noncompetitive behavior, credit availability will be further reduced. Sales credit rate ceilings may cause creditors to shift a portion of the finance charge into the cash price, thereby forcing cash buyers to subsidize credit buyers. Such ceilings probably also force some firms from the market, leading to greater concentration.

Restrictions on loan size and maturity. Legal restrictions specifying the maximum amount or maturity of credit can result in terms that are unacceptable to some potential credit users. Consumers most likely to be affected by these limitations are those in the risk class most commonly served by finance companies and by retailers catering to high risk credit buyers. These consumers often desire as much credit as possible with low monthly payments. Faced with an artificial restriction on maturity or size of loan, for example, a potential high risk borrower has four main alternatives: (a) to seek a loan at another source which has no restriction, (b) to reduce credit expectations and accept the small loan, (c) to attempt to obtain two small loans, or (d) to do without. The first alternative is usually not feasible for the typical borrower served by finance companies. The second, like the first, results in reduced availability from the finance company sector. The third, termed "doubling up" in the trade, may overcome the restriction on availability but usually results in significantly higher costs (because of graduated rate structures, two small loans are commonly more expensive than one larger loan and this is a form of restriction on availability).

Limitations on creditors' remedies. Restriction on creditors' remedies make the creditors' position less favorable than if they had full use of all legal collection tools. In the face of limitations on remedies a creditor can either (1) increase rates to cover added collection costa and bad debt losses or (2) maintain the same rates but exercise more selectivity in granting credit. To the extent that borrowers are sensitive to rates charged for credit, the first option will find less demand for credit at the higher price. The second will result in fewer qualified borrowers. Both will result in reduced availability.[2]

Barriers to entry. Because the principles of free competition are based in part on ease of entry for new suppliers, any barriers to entry can lessen competition. Barriers are not limited to the commercial bank, credit union and finance company sectors studied by the Commission. It is possible that savings and loan associations and mutual savings banks could stimulate competition if allowed to broaden their consumer credit activities in states which now restrict them. Another significant legal barrier in consumer credit markets is that of convenience and advantage (C & A) licensing for finance companies under many state laws. By limiting licenses under strict construction of the law to offices that serve the "convenience" and "advantage" of the community, states inhibit competition from new firms. Although the intent of C & A licensing is purportedly to encourage the growth of the size of loan offices to attain economies of scale, misdirected application of the rule can lead to substantial lack of competition. Moreover, Commission studies reveal no significant economies of scale.[3]

Market concentration. When it leads to the exercise of market power, market concentration can affect availability in two ways. First, the traditional exercise of market power is indicated by an increase in prices followed by a reduction in the amount of credit demanded. Second, firms may ration credit by refusing to serve some qualified borrowers. By accepting only selected credit risks, a firm can maximize its excess profits.

The New Automobile Credit Market[4]

Commission findings on the price and availability of new automobile credit, presented in this section, cover (1) the structure of the market to illuminate subsequent interrelationships among various sectors of the market; (2) the associations between those factors and the price of new automobile credit at commercial banks and finance companies; (3) the availability of new automobile credit; and (4) conclusions about the observed operations of the new automobile credit market.

Market structure. Major suppliers of automobile credit are banks (including mutual savings banks), credit unions, and finance companies. Commercial banks may participate in two ways: (1) direct lending, and (2) the purchase by banks and finance companies of consumer instalment contracts (purchased paper) from retail automobile dealers (termed "indirect financing"). The national market share for each of the major supply components studied is shown in Exhibit 7-1.

EXHIBIT 7-1

National Market Shares of Major Sources of New Automobile Credit Extended, Dollar Amounts, Second Quarter, 1971.

Source	Percent Market Share
Bank direct loans	32.3
Credit union direct loans	15.4
Bank purchased paper	29.8
Finance company purchased paper	22.5
	100.0

Source: Data are based on the National Commission on Consumer Finance 1971 Consumer Finance Survey (unpublished)

The structure of the market can be viewed from two perspectives: either the demand for credit (the borrower view) or the supply of credit (the supplier view). From the borrower's standpoint there are four alternative institutional sources of credit—banks (including mutual savings banks, and other miscellaneous lenders), finance

companies, credit unions, and (to a limited extent) automobile dealers. Because credit unions lend only to members, their market is more restricted than that of banks and finance companies. However, 29 percent of the loans outstanding at Federal credit unions at mid-1970 were made to finance automobiles,[5] and their share of the consumer instalment credit market has increased steadily over the past decade.

On the supply side, the bulk of retail sales financing of new automobiles comes from three credit sources—commercial banks indirectly, finance companies indirectly, and retailers, themselves. Automobile dealers typically sell their instalment contracts to more than one financial institution. Generally, there is a gradation of risk acceptable to financial institutions, with finance companies usually willing to accept a higher average degree of risk than commercial banks. For example, a dealer may sell a very prime contract to a commercial bank and charge the customer a relatively low rate, knowing the customer might otherwise borrow directly from his bank or credit union. An instalment contract arranged with a less creditworthy consumer might be rejected by the bank and sold to a finance company. Since the finance company and dealer perceive the higher risk, the consumer is likely to pay a higher APR. The dealer's participation in the finance charge—the difference between the buying rate of the finance company and the rate charged the consumer—may also be higher than on the contract sold to the bank, if the dealer's agreement with the finance company requires that he repurchase the car in the event that it is repossessed. Finally, the finance company may be unwilling to finance a very risky consumer unless the dealer agrees to pay off the contract in event of default. To offset his still greater risk, the dealer will charge that consumer an even higher rate than in the previous two cases. Consumers are typically told by the dealer that he is arranging to sell the contract to a bank or finance company where payments must be made.

Mainly by use of advertising direct lenders compete with automobile dealers for the business of new car customers. Potential new car purchasers, then, can arrange for credit at the dealer's or obtain direct loans from banks, finance companies, credit unions, or other financial institutions with choice presumably based on knowledge of differences in prices and availability.

Rates of Charge (APR's) for New Auto Credit

How are the several market rates of interest (APR's) related to each other—are they positively intercorrelated across states, or do variances tend to be random in relation to each other? The answer to this question at the outset is important, because if certain reasonably clear patterns of association are apparent, the explanations for the associations must first be sought out. If, however, there appears to be little or no interstate association among the rates, the rates for each source could be discussed without regard to possible interdependencies.

Exhibit 7-2 presents a correlation matrix of the interstate variances of interest rates charged on new auto credit by major credit grantors, with commercial banks and finance company direct and indirect customer rates shown separately. Inspection of the matrix discloses that many of the rates are, indeed, highly correlated. By definition some of the correlations should be significant. For example, the indirect customer rates for banks and for finance companies are each comprised of a dealer participation rate and a net indirect institutional rate. It is to be expected, therefore, that the commercial bank indirect customer rate would be highly correlated with the commercial bank dealer participation rate and the commercial bank indirect net rate. Similarly, the significant correlation between finance company indirect customer rate and its two components—finance company dealer participation rate and finance company indirect net rate—came as no surprise. Indeed, the definitional relationships generate some of the highest correlations in the matrix—particularly the correlation between finance company indirect customer rate and finance company dealer participation rate (+.901) and the correlation between commercial bank indirect customer rate and commercial bank dealer participation rate (+.779). Thus it appears that retail dealers, through markup on their interest rates, account for most of the interstate variance of indirect customer rates.

A second set of correlations are also to be expected even though the rates are not related by definition. These are the correlations which occur between two rates that are set by the same decision making units. Commercial banks establish both a direct customer rate and an indirect net rate, and the correlation between these is +.591. Similarly, dealers exercise substantial influence in establishing both the commercial bank dealer participation rate and the finance company dealer participation rate. The correlation between these two rates is +.777. It appears, then, that common causal forces underly each pair in this second set of correlations. Moreover, the high correlation between the two dealer rates must certainly contribute substantially to the +.626 correlation between the finance company dealer participation rate and the commercial bank indirect customer rate, the +.673 correlation between the commercial bank dealer participation rate and the finance company indirect customer rate, and the +.693 correlation between the commercial bank indirect customer rate and the finance company indirect customer rate.

EXHIBIT 7-2

Correlation Matrix of New Auto Credit Interest Rates (APR's) Across 39 States

	Commercial Bank Direct Rate	Commercial Bank Indirect Customer Rate	Finance Company Indirect Customer Rate	Commercial Bank Dealer Participation Rate	Finance Company Dealer Participation Rate	Commercial Bank Indirect Net Rate	Finance Company Indirect Net Rate	Credit Union Direct Rate
Commercial Bank Direct Rate	1.000	.532**	.211	.192	.038	.591**	.409**	.272
Commercial Bank Indirect Customer Rate		1.000	.693**	.779**	.626**	.553**	.371*	.152
Finance Company Indirect Customer Rate			1.000	.673**	.901**	.206	.539**	.156
Commercial Bank Dealer Participation Rate				1.000	.777**	-.091	.032	.155
Finance Company Dealer Participation Rate					1.000	-.038	.120	.156
Commercial Bank Indirect Net Rate						1.000	.546**	.034
Finance Company Indirect Net Rate							1.000	.063
Credit Union Direct Rate								1.000

*Significant at the 5 percent level

**Significant at the 1 percent level

Note that the Commercial Bank Dealer Participation plus Commercial Bank Indirect Net Rate equals the Commercial Bank Indirect Customer Rate and that the Finance Company Dealer Participation plus the Finance Company Indirect Net Rate equals the Finance Company Indirect Customer Rate.

States omitted because of incomplete data: Alaska, Delaware, District of Columbia, Hawaii, Kansas, Montana, New Hampshire, North Dakota, Rhode Island, South Dakota, Vermont, and Wyoming.

Finally, there is a third set of pairings which generate high positive coefficients but which have no obvious reason to be highly correlated. For example, the finance company indirect net rate and the commercial bank direct rate are significantly correlated (+.409). The correlation between finance company indirect net rate and the commercial bank indirect net rate (+.546), too, is significant. Though not significant, the commercial bank dealer participation rate is somewhat correlated with the commercial bank direct rate, suggesting that where the commercial bank direct rate is relatively high and demand shifts from commercial banks to retailers, retailers may be able to charge higher markups on their rates than they otherwise would. Since most of these otherwise unexplained relationships concern the commercial bank direct rate for new auto credit, it appears from Exhibit 7-2 that if any one of the interest rates for new auto credit could be considered a "pivotal" or "focal point" rate, it would be the commercial bank direct rate. Knowledge of the determinants of the commercial bank direct rate would probably contribute to a better understanding of the commercial bank

indirect net rate, the finance company indirect net rate, and, perhaps, the commercial bank and finance company dealer participation rates. Since commercial bank and finance company indirect customer rates are comprised of these latter four rates, an understanding of them would follow automatically.

Credit union rates for new auto credit are not significantly correlated with any other rates, but even here, the credit union direct rate is most closely associated with the commercial bank direct rate.

Commercial bank direct new auto credit. The Commission staff analysis of interstate variations in the average of rates of charge for commercial bank direct new auto credit shows that the average rate is positively associated with bank concentration (the share of direct extensions accounted for by the four banks with the largest extensions of direct new auto credit), the average interest rate paid on commercial bank time deposits (the surrogate for the cost of capital) and the type of banking structure permitted within the state. Other variables tested, but not sufficiently correlated to be statistically significant were bank salary expenses per employee, bank delinquency rates, unemployment rates, rate ceilings, bank growth rate, volume of bank nonconsumer credit business, and volume of bank nonauto credit business. The lack of significance for a legal rate ceiling variable is suggested by Exhibit 6-2, which shows that in most states rates typically charged on this class of loan were well below the ceiling rate. Among those few states where rate ceilings can be said to have a definite restrictive effect on price, Arkansas, which has relatively low bank concentration (16 percent), has a rate ceiling of 10 percent (APR) and an average typical reported rate of 10.12 percent. It appears that a significant number of new car bank loans there are made at illegal rates unless Arkansas law requires or permits a method of computing charges different from the actuarial method.

The variable having the greatest statistical significance is the average interest rate paid on commercial bank time deposits. If the average time deposit rate were 5 percent in one state and 6 percent in another, that differential is associated with a variation of not quite half of 1 percent (0.454 percent) in the average APR charged on direct auto loans by banks (holding the concentration ratio constant).[6]

The other highly significant variable is the bank concentration ratio. On average, a 10 percentage point difference in bank concentration (say, 50 percent versus 60 percent) is associated with a 0.1 percent variation in the APR (0.098 percent) on direct auto loans. This relationship between observed APR's and expected APR's on direct new auto loans by commercial banks at various levels of market concentration, with other factors held constant, is illustrated in Exhibit 7-3. Actual observed APR's do not correspond exactly to the predicted APR's because the observed data reflect uncontrolled unidentified factors assumed to be random. Examination of some states that appear to deviate from the norm reveals some plausible explanations for such behavior. For example, the low APR in Maryland probably reflects competition from banks and Federal credit unions in the District of Columbia. In states where rates are higher than predicted, the result may reflect unexplained cost factors or a lesser degree of competition than expected.

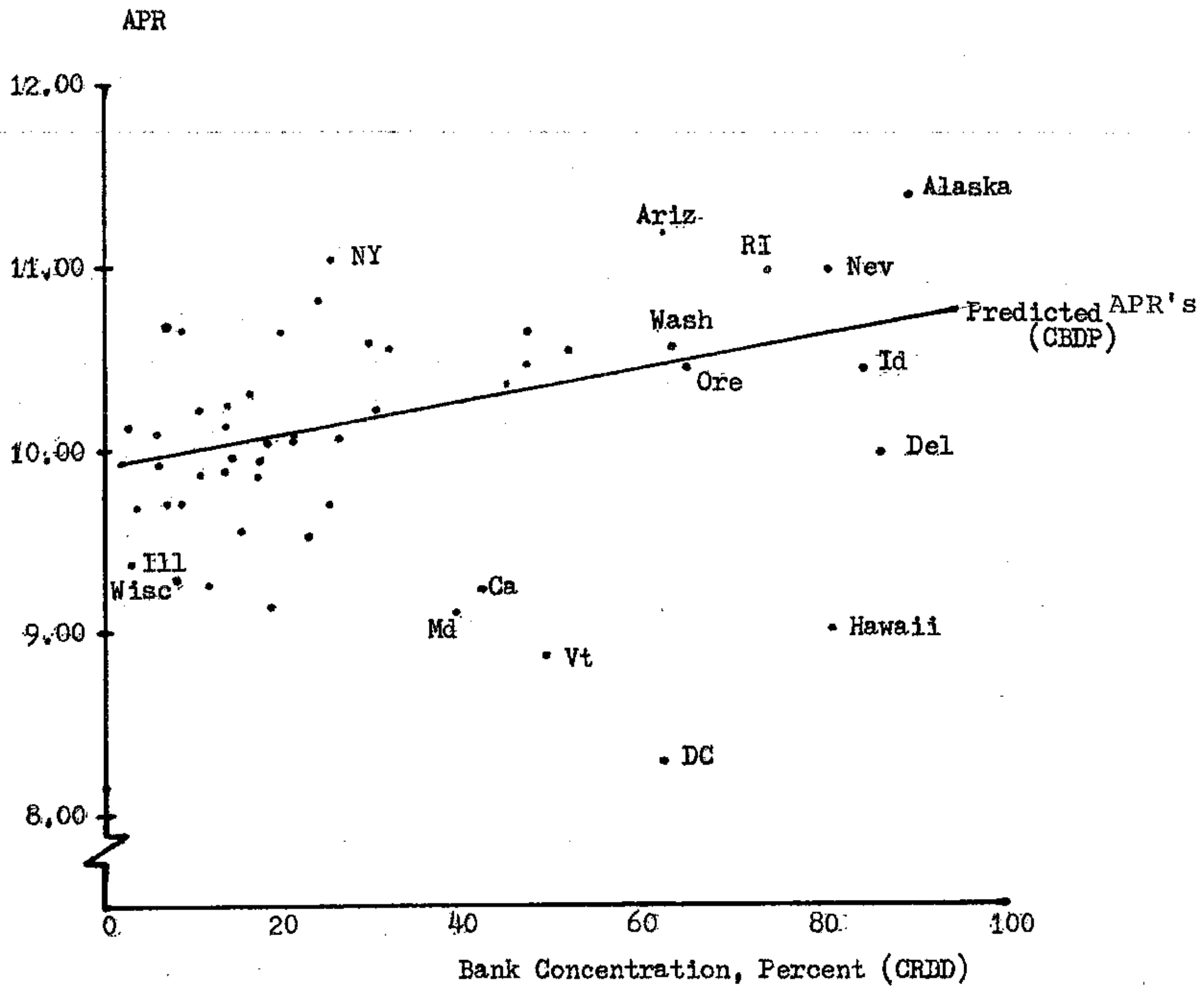
Despite such deviations, there is, on average, an observable association between the APR on direct new auto loans and bank concentration that is unlikely to have occurred by chance. Responsiveness of the APR to differences in the bank concentration ratio among the states is not great, but the large differences in concentration ratios among the states support the hypothesis that market power, as evidenced by market concentration among commercial banks, is associated with substantially higher average rates of charge for new car loans.

Analysis of the data reveals a high correlation between bank concentration and branch banking privileges (Exhibit 7-4). Replacement of the concentration ratio in the analysis with variables representing the presence of limited or statewide branching shows that, with differences in commercial bank time deposit rates held constant, a state with statewide branching privileges has, on average, APR's averaging 0.41 percentage points higher than those in unit banking states. Although the nature of the relation of concentration and branch banking to rates and availability of credit is detailed more fully later, the *existence* of market power does not always result in the *exercise* of that power. For example, banks in Delaware show relatively high concentration (89 percent) but the average reported ratio is relatively low, 9.98 percent (Exhibit 7-4). Nor do statewide branching privileges always result in extremely high bank concentration. California, which permits statewide branching, has only 37 percent concentration and an average reported APR on direct new auto loans of 9.23 percent. It is apparent that the presence of a large number of banks (excluding branches) and credit unions in California greatly stimulates banking competition. Yet these cases are exceptions to the significant average relationships of concentration and status of statewide branching to the APR's among all of the states included in the analysis.

The commercial bank direct rate is probably the single most important rate in the new auto credit market, because it is the "pivotal" rate, much like the prime rate functions in the commercial loan market. Other new auto credit rates appear keyed to it. In addition to being heavily influenced by the commercial

EXHIBIT 7-3

Bank Concentration and the Rate of Charge for Commercial Bank Direct New Automobile Loans



Note: Dots represent observed average prices. The predicted price is based on the following regression equation:

$$CBDP = 5.73 + \underset{(.0034)}{0.0098}\ CRDB + \underset{(.77)}{2.49}\ LTDI,$$

where CRBD is bank concentration in the direct loan market and LTDI is the logarithm of the average time deposit rate for commercial banks; LTDI is held constant at its average value of 1.66, T ratios are below the regression coefficients.

The following states were omitted from the regression analysis because of incomplete data: Alaska, Delaware, District of Columbia, Hawaii, Kansas, Montana, New Hampshire, North Dakota, Rhode Island, South Dakota, Vermont, Wyoming. Observed values are plotted when available.

Exhibit 7-4

Observed Rates Charged for Direct New Auto Credit at Commercial Banks in States with Highest and Lowest Bank Concentration

High Concentration States	Concentration Ratio	Type of Branching [a]	Observed Rate
Alaska	89.9	SB	11.38
Delaware	86.0	SB	9.98
Idaho	86.8	SB	10.42
Nevada	84.7	SB	10.97
Rhode Island	71.2	SB	10-97
Washington	66.6	SB	10.55
Arizona	64.6	SB	11.16
Oregon	62.9	SB	10.43
South Carolina	55.8	SB	10.53
North Carolina	51.0	SB	10.66
Average	72.0		Average 10.71
Low Concentration States			
Montana	10.6	LB	9.86
Indiana	9.7	LB	10.21
Wisconsin	8.8	LB	9.28
Kansas	7.6	UB	9.70
Oklahoma	7.5	UB	10.67
Iowa	6.1	UB	9.82
Minnesota	4.6	UB	10.10
Texas	2.8	UB	10.11
Illinois	2.6	UB	9.37
Average	6.7		Average 9.90

(a) SB = Statewide branch banking
LB = Limited branch banking
UB = Unit banking

Source: National Commission on Consumer Finance Survey of Consumer Credit Volume, Second Calendar Quarter, 1971, and Consumer Credit Outstanding, June 30, 1971.

Note to Exhibit 7-4

Statewide Branch Banking States	Limited Branch Banking States	Unit Banking States
Alaska	Alabama	Arkansas
Arizona	Georgia	Colorado
California	Indiana	Florida
Connecticut	Kentucky	Illinois
Delaware	Louisiana	Iowa
Hawaii	Massachusetts	Kansas
Idaho	Michigan	Minnesota
Maine	Mississippi	Missouri
Maryland	New Hampshire	Montana
Nevada	New Jersey	Nebraska
North Carolina	New Mexico	North Dakota
Oregon	New York	Oklahoma
Rhode Island	Ohio	Texas
South Carolina	Pennsylvania	West Virginia
Utah	South Dakota	Wyoming
Vermont	Tennessee	
Virginia	Wisconsin	
Washington		
District of Columbia		

496-072 O - 73 - 10

bank direct rate, the other major new auto credit rates—particularly the finance company net rate and the finance company and commercial bank dealer participation rates—are in part determined by risk costs and size and efficiency of retail dealers. In some states—those with low rate ceilings—the finance company indirect customer rate, dealer participation rate, and net rate are largely functions of the legal rate ceiling.[7]

Availability of new auto credit

Since the preceding discussion of new automobile credit rates indicated the likelihood of market imperfections in some states, the new automobile credit market cannot be generally characterized as having full availability. To assess the relative availability of new automobile credit, relationships between the amount of credit actually extended per family within each state and factors explaining the variation in these amounts are examined. In new automobile credit markets the primary factors that appear to affect availability are legal rate ceilings and noncompetitive behavior of some credit suppliers. The latter is suggested by the relationship between market concentration and rates paid for credit in some market segments. When bank concentration in the automobile credit market is high, for instance, the associated higher rates charged for credit result in less credit. However, analysis of the market structure suggests that the availability of auto credit from each of the market segments does not follow the same pattern. When the amount of direct automobile loans supplied by banks is low (because of demand), the amount supplied by dealer financing is higher (also because of demand).

Consumers who typically borrow directly from banks (or credit unions) can be characterized as less cash-constrained, less risky and more sensitive to rates charged for credit than those who generally finance through automobile dealers. In economic terminology, bank customers for new auto direct credit appear to have a higher price elasticity of credit demand. As rates charged for credit increase, the amount of credit demanded decreases. A 10 percent rise in the average APR on direct auto loans at banks can be expected to reduce the dollar amount of bank auto loans sought by 29 percent while the average APR's for dealer financing stay the same. Of consumers who choose not to borrow from banks when rates are higher, one-half can be expected to buy on cash terms while the other half will rely on dealer financing. Since the average APR in dealer financing is generally higher than the average APR in direct bank financing, the demand shift to retailers must be explained by such nonrate considerations as (a) convenience of dealer financing; (b) more favorable nonprice credit terms from dealers (for example, longer maturities and lower downpayment); (c) less credit shopping when there is little variation in rates charged by alternative sources; and (d) possibility of nonprice credit rationing by banks. The last factor implies that banks may find it profitable to encourage a shift to dealer financing, some of which is supplied indirectly by banks. Although the banks' net rate on purchased paper may be somewhat less than on direct loans, some portion of the risk may be shifted to dealers through recourse arrangements, and some direct loan costs, such as advertising, are substantially lower when paper is purchased from auto dealers. For these reasons, a higher level of dealer financing co-exists with lower availability of direct bank credit. Also, shifts by some consumers to cash buying implies that total credit availability is somewhat less when the higher rates result from noncompetitive behavior on the part of the suppliers. There is some evidence to support this, as indicated earlier with regard to rates of charge, and it applies equally to availability.

Commercial bank direct loans. The amounts of commercial bank direct new automobile credit supplied are related significantly to branch banking structure and concentration.

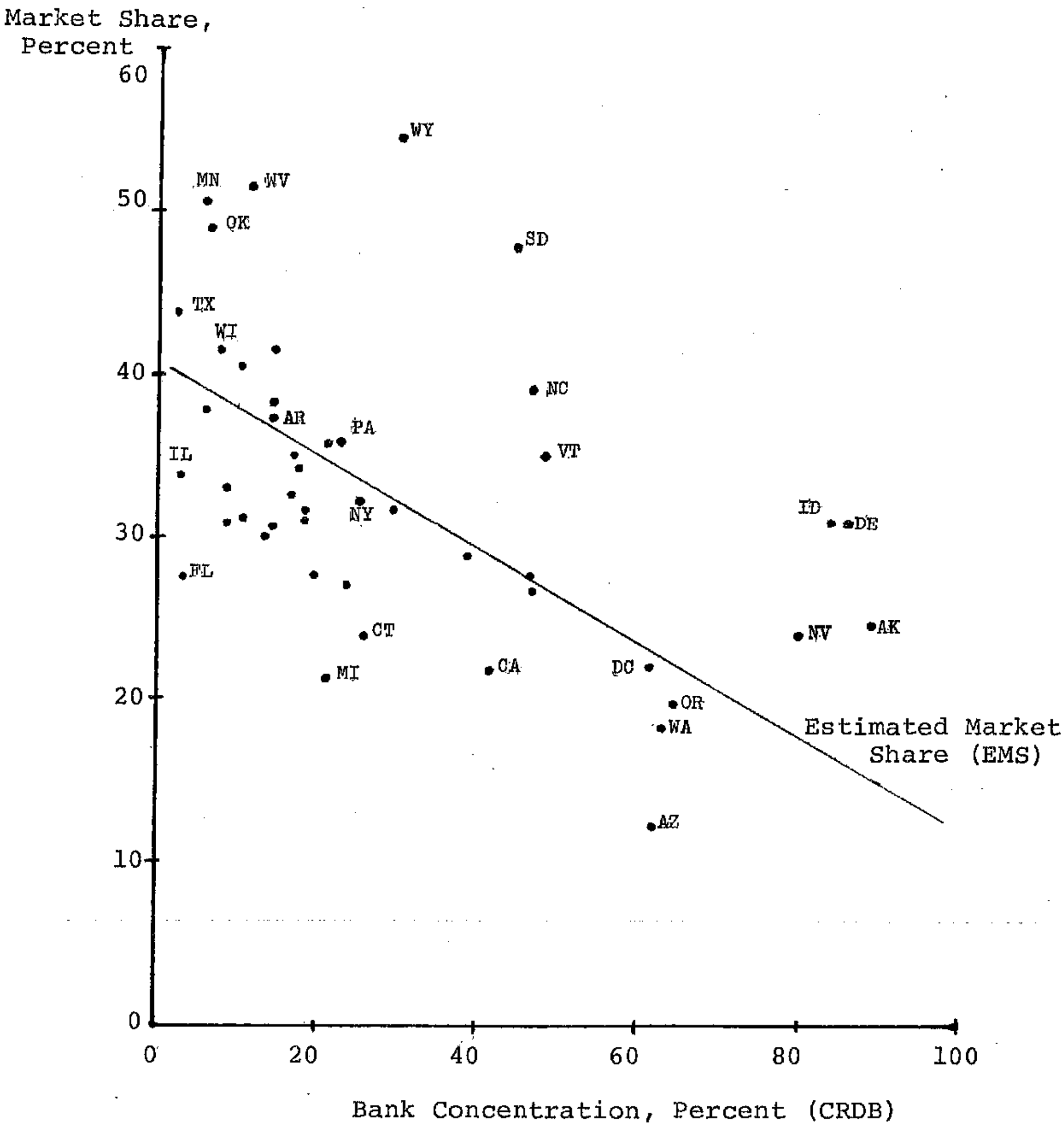
Commercial banks in states permitting statewide branching on average supply approximately $18 per thousand households less direct auto credit than banks in unit banking states, other things being equal. Similarly, limited branching states supply, on average, approximately $11 per thousand households less than banks in unit banking states. Since the average amount supplied by banks in the 39 states analyzed was approximately $30 per thousand households, branching structure would appear to have a substantial effect. The lesser amount of direct bank auto credit per thousand households can partly be traced to differences in bank concentration ratios, particularly statewide branching states where concentration ratios are higher (the simple correlation being .85).

The higher rates associated with branch banking and bank concentration result in lower use of direct auto credit seemingly because of negative reaction by consumers to the higher rates. But, whether or not rate sensitivity causes the shift, the general pattern of association between bank concentration and credit availability in the bank new auto credit market is unchanged. As shown in Exhibit 7-5, high levels of bank concentration are generally associated with a lower direct bank loan share of the total automobile credit market. This implies that dealer financing is correspondingly higher.

The association of higher concentration ratios with higher APR's does not *prove* the exercise of market power, since the same set of data could be consistent

EXHIBIT 7-5

Bank Concentration and Market Share: Dollar Volume of Direct Automobile Loans as a Percent of Total Automobile Credit Extended



Note: The estimated market share is based on the following regression equation:

$$EMS = 38.69 - \underset{(.052)}{.236}\ CRDB$$

with other hypotheses. Indeed, statewide concentration ratios, whatever their level, fail to reflect accurately the realities of individual geographic markets for consumer credit within the state.

Commercial bank indirect financing at auto dealers. As suggested earlier, credit availability in this segment of the market is positively associated with bank concentration, indicating a shift in demand from bank direct loan customers to dealer financing in response to narrowed rate differentials between the two markets. Legal rate ceilings also significantly influence availability in the bank new auto indirect loan market. The size of the implied curtailment, 16 cents per household for each percentage point difference in the ceiling APR, is not large. As expected, the growth of banks and a higher level of real income are also associated with higher availability, while a higher cost of capital has a negative effect.

Finance company credit at auto dealers. It appears that the supply of automobile credit from finance companies is not associated with bank concentration. Any shift from the direct bank sector is directed primarily into the cash market and the bank indirect credit market at dealers. This is not surprising in view of the risk gradation among the sectors of the automobile credit market. Since finance companies tend to accept higher risk contracts that carry higher rates, the sales finance contracts of consumers who shift from the direct bank market to dealer financing will gravitate toward the bank indirect sector rather than the finance company indirect sector.

Bank concentration and sources of auto financing. Overall implications of the foregoing findings are illustrated by examining the different sources of automobile financing and the average rates charged for credit in two groups of states with the highest and lowest bank concentration ratios.[8] Exhibit 7-6 shows, for each group, the average percent of automobile sales financed at the various credit sources and the average rate for credit, based on observed values. In the low concentra-

EXHIBIT 7-6

Bank Concentration and the Source and Rates Charged for Automobile Credit in 10 High and Low Concentration States

Source of Financing	High Concentration States*		Low Concentration States*	
	Average Percent of Auto Sales Financed at Source	Average Rate of Charge for Credit (APR)	Average Percent of Auto Sales Financed at Source	Averge Rate of Charge for Credit (APR)
Direct Loans				
Banks	15.84	10.73	27.37	9.97
Credit Unions	10.68	11.36	10.07	11.23
	26.52		37.44	
Dealer Financing				
Banks	25.32	12.73	15.58	12.08
Finance Company	16.20	12.35	11.54	12.33
	41.52		27.12	
Cash Sales and Other**	31.96		35.44	
Total	100.00		100.00	

*High concentration states (average concentration ratio of 64 percent): Arizona, Nevada, Oregon, South Carolina, Washington

Low concentration states (average concentration ratio of 6 percent): Illinois, Iowa, Montana, Oklahoma, Texas

**"Other" includes dealer-held finance contracts and all miscellaneous sources.

The relationships shown in this Exhibit and in Exhibits 7-10, 7-11 and 7-12 are supported by significantly regression coefficients in staff econometric studies.

tion group (states with an average concentration ratio of 6 percent), an average of 27.37 percent of all auto sales are financed directly at banks at an average APR of 9.97 percent for direct loans. In the high concentration group (states with an average concentration ratio of 64 percent), only 15.84 percent of all auto sales are financed directly at banks, and the average APR is 10.73 percent for direct loans. The pattern is reversed for dealer financing. In the low concentration group, only 27.12 percent of sales are financed through dealers: in the high concentration group 41.52 percent of sales are so financed. Within the dealer financing market, the larger change occurs in the banks' share, with a higher rate for bank credit in the high concentration group. The pattern of credit union financing is not significantly different in the two groups.

This illustration discloses the significant association between bank concentration and rates and sources of automobile financing. But not all states follow the same pattern, nor do all states within each of the illustrative groups.

Conclusions on New Auto Credit Market

Average rates charged for new automobile credit at banks and automobile dealers, and associated distribution of automobile financing at alternative credit sources, are related significantly to the cost of bank capital, bank concentration, and banking structure. High cost of capital and high levels of bank concentration, most often associated with statewide branch banking, are generally associated with higher average rates for direct bank new auto loans and less automobile financing of that type. More financing is obtained through automobile dealers, and at still higher rates, because dealers charge higher rates in those states with less rate competition from bank direct loans. However, credit union loan volume and rates seem to be unaffected by the behavior of the other market sectors. Although some interstate variations in the pattern and cost of automobile financing are the result of restrictive rate ceilings in a few states, the major differences are associated with bank concentration.[9] Bank operating costs may be partly responsible for higher rates of charge, but the staff research suggests they are not the primary factor.

These observations suggest that noncompetitive elements in some states are associated with high bank concentration. However, market concentration does not inevitably result in noncompetitive behavior, nor does branch banking inevitably result in high bank concentration. After review of other credit markets, the Commission will offer recommendations to improve the competitive environment of all consumer credit markets.

The Other Consumer Goods Credit Market

The second major consumer credit market consists of credit extended for the purchase of consumer durable goods other than automobiles, mobile homes, boats, aircraft, and recreational vehicles. Household goods and apparel are major components of this market. Major suppliers of this kind of credit are banks, credit unions, finance companies, and retail stores.

Market Structure

Credit purchase of Other Consumer Goods (OCG) can be financed by one of two forms of instalment credit: (1) closed end credit, wherein the contract maturity is fixed at the time credit is granted, or (2) open end or revolving credit, wherein a series of credit purchases may be charged to a single account on which the consumer must pay a part of the periodic balance. The credit buyer who seeks instalment credit has several alternatives: (1) direct loans from banks; (2) direct loans from credit unions; and (3) instalment sales financing through retail stores.[10] Retail sales financing, in turn, may be supplied directly by retailers or indirectly by banks and finance companies that purchase sales finance contracts from retailers. The amount of credit supplied at the national level in each of these categories during the second quarter of 1971 is shown in Exhibit 7-7. The total of \$9.128 billion from the Commission survey represents approximately \$134 per family, with 62 percent of this total supplied in the form of revolving credit. Within the closed end instalment credit sector, retailers clearly represent the largest direct source, with 46 percent in that category.

Bank and credit union direct loans represent less than 20 percent of total OCG instalment credit. Over 80 percent is arranged through retailers. In addition, retailers supply over one-half of revolving credit extensions. Retail-originated financing predominates for two major reasons: convenience of credit, and some risk segmentation of the market. Because OCG credit is regarded primarily as a convenience, factors such as location of credit source and ease of accessibility are primary considerations. Although the finance rate is higher than rates for new car financing, the dollar amount of finance charges is relatively small because of the smaller average cost of purchases. Consequently, consumers are more interested in convenience than in credit price which leads them to retailers. Opportunities to shop for credit at banks and credit unions may be limited to the better credit risks who want to finance relatively large purchases. Even the better credit risks do not always seek direct loans at banks and credit unions because the convenience of retailer financing or bank

EXHIBIT 7-7

Other Consumer Goods Instalment Credit Extensions by Major Sources, Second Quarter, 1971

	Total Extensions, All States (in $ millions)	Percent of Total
Closed-end Credit		
Retail direct extensions	$1,584	46.1
Bank direct loans	398	11.6
Credit union loans	280	8.2
Bank indirect financing through retailers	595	17.3
Finance company indirect financing through retailers	576	16.8
Total Instalment Credit	$3,433	100.0
Revolving Credit		
Retail revolving credit	$3,224	56.6
Bank revolving credit	2,471	43.4
Total Revolving Credit	$5,695	100.0
Total Other Consumer Goods Credit	$9,128	100.0

Source: National Commission on Consumer Finance Survey of Consumer Credit Volume, Second Calendar Quarter, 1971, and Consumer Credit Outstanding, June 30, 1971. Data from the Board of Governors of the Federal Reserve System show total extensions (not seasonally adjusted) of $10,049 million.

revolving credit may outweight the cost advantages of direct loans, especially for smaller purchases.[11]

The prevalent use of revolving credit is also related primarily to convenience. Consumers with high incomes or high levels of liquid assets may use credit cards primarily for the convenience of repaying obligations with little or no finance charges. Besides the convenience of purchasing goods under a line of credit, revolving credit is attractive for some consumers because its lack of fixed monthly payment requirements (beyond a minimum amount) permits consumers to modify payment patterns to meet their own needs.

Analyses of OCG credit focused on the three major forms of OCG financing: (a) revolving credit, (b) direct loans from banks and credit unions and (c) retailer-originated closed end instalment financing for which the following general observations are presented.

Finance Rates and Availability

Revolving Credit. The supply of revolving credit from banks and retailers is generally responsive to the demand for revolving credit, with credit rationing unlikely except on the bases of rate and credit risk. Thus, most creditworthy borrowers are likely to be able to obtain credit cards. This is especially true in the case of retail revolving credit since the primary impetus to the granting of retail credit via credit cards is the promotion of retail sales in competition with other retailers who also offer credit. From the consumers' viewpoint, demand for revolving credit is higher from younger families and increases with higher incomes. In addition, interstate variations in revolving credit usage are positively related to marriage rates within the states and the level of OCG sales.

Since the finance rates on bank and retail revolving credit are typically near 18 percent and show little inter-state variation, it is difficult to assess the relationship between rates and availability. Moreover, the potential effect of restrictive rate ceilings is difficult to evaluate empirically because of the possibility that finance charges may be hidden in the price of the goods sold. Thus, cash buyers (some of whom may have been unable to obtain credit) and better credit risks may subsidize credit extensions to higher risk consumers to an extent such that there is little effect on overall availability. However, Exhibit 7-8, which shows the level of revolving credit usage for a subset of 11 states with

EXHIBIT 7-8

Revolving Credit Rates and Availability: A Subset of States with Below-Average Rates

State	Bank and Retail Revolving Credit ($ per Family)	Average Bank APR on $100 - Revolving Credit Card Balance (percent)	Average Retail APR on Revolving Credit (percent)
Arizona	$124	15.96	18.00
Arkansas	59	D	10.08
Iowa	49	12.09	18.00
Kansas	63	18.00	14.92
Minnesota	87	NR	14.11
New Jersey	59	12.63	18.00
Oregon	84	15.00	18.00
Pennsylvania	66	15.00	15.12
Washington	107	12.00	12.00
West Virginia	51	15.84	18.00
Wisconsin	71	15.91	12.00
Single average for group	$74.5	14.71[b]	15.29
Average for all States[a]	$80	17.20[c]	17.24

D = unavailable because of disclosure restrictions

NR = no reported data

(a) States not included because of data disclosure restrictions: Alaska, Montana, District of Columbia

(b) Arkansas and Minnesota excluded

(c) States not included because of data disclosure restrictions: Alaska, Arkansas, Hawaii, Minnesota, Montana, North Dakota, South Dakota, District of Columbia

Source: National Commission on Consumer Finance Survey of Consumer Credit Volume, Second Calendar Quarter, 1971, and Consumer Credit Outstanding, June 30, 1971.

below-average rates, indicates that lower rates of charge may be related to lower availability.

Direct Loans from Banks and Credit Unions. Data on finance rates on direct OCG loans from financial institutions are not available because OCG loans are often recorded as personal loans, rather than being classified separately. In this case, however, it is reasonable to assume that bank rates would be approximately equal to the rate on a comparable personal loan. Similarly, credit union OCG loans would be expected to yield approximately 12 percent, the predominant rate of state and Federally chartered credit unions. Although the effects of creditors' remedies, rate ceilings and competition could not be determined in the absence of rate data, it is likely that conclusions reached for the bank personal loan market would apply here as well.

The staff's interstate analysis indicates that demand for direct OCG credit, relative to OCG sales, is positively associated with higher income, higher marriage rates and higher rates of charge on retail-originated instalment financing. The data also suggest that the supply of credit is restricted by restrictions or prohibitions against garnishment and wage assignments. The data also show that lower credit availability is associated with high levels of bank concentration, although credit union concentration is unrelated. The extent of this association is illustrated in Exhibit 7-9 which shows the levels of direct OCG loan extensions relative to sales and bank concentration for two subsamples of states with high and low credit availability. Although this simple comparison neglects other demand and supply factors, the staff's econometric analysis shows that the negative relationship between concentration and supply is statistically significant even when other factors are taken into consideration. Thus, these findings are consistent with the analysis of the new automobile direct credit market.

Retail-originated Closed End Instalment Credit. The analyses of finance rates on retail instalment credit involved the examination of three supply components: retailers, commercial banks and finance companies. The

EXHIBIT 7-9

Market Concentration and the Percent of Other Consumer Goods Sales Financed Directly at Banks and Credit Unions

	Average of 12 States with Highest Percent of Direct Loan Financing[a]	Average of 12 States with Lowest Percent of Direct Loan Financing[b]
Percent of OCG Sales Financed Directly at Banks and Credit Unions	8.4 %	3.3 %
Bank Concentration[c]	40.3 %	59.5 %

[a] States included: Utah, New Mexico, Idaho, Colorado, Michigan, Alabama, Nevada, Iowa, North Carolina, Virginia, Texas, Florida

[b] States included: Maryland, Missouri, Hawaii, Mississippi, Vermont, Washington, Pennsylvania, California, Arizona, Delaware, New Jersey, New York

States dropped from consideration because of disclosure restrictions or questionable data: Alaska, Arkansas, Kansas, Kentucky, Louisiana, Maine, Montana, North Carolina, North Dakota, Oklahoma, Rhode Island, South Dakota, West Virginia, Wyoming, District of Columbia

[c] Four-firm concentration ratio (percent) for commercial bank and mutual savings bank direct OCG loans

Source: National Commission on Consumer Finance Survey of Consumer Credit Volume, Second Calendar Quarter, 1971, and Consumer Credit Outstanding, June 30, 1971.

analyses of finance rates on sales finance contracts originated and held by retailers indicate that interstate variations in rates are not highly correlated with rate ceilings or creditors' remedies. Although operating cost data were not available for analysis, there is some indication that rate levels are positively related to the interest rate on bank time deposits, which is a surrogate measure of the cost of funds. In addition, there is some indication that rates on direct retail credit are somewhat lower when concentration among the bank and finance company suppliers of retail credit is high. This may indicate some competition and efficiencies of scale for the bank and finance company suppliers of retail credit. However, the results are largely inconclusive since these explanatory factors account for only 20 percent of the interstate variations in rates. It is possible that the high unexplained variation is a result of finance charges being hidden in the price of goods when rate ceilings are low or when other market imperfections exist.

The analyses of finance rates on retail credit supplied indirectly by finance companies indicate that approximately 46 percent of the interstate variation in rates is due to legal rate celings. It is also apparent that higher levels of finance company concentration tend to be associated with a lower dealer APR participation rate (the portion of the customer APR retained by the retailer), although there is no correlation with the net finance company rate. This may indicate that large sales finance companies either use market power to increase their share of the finance charge or limit their acceptable credit risk to a greater extent than the smaller firms, thereby reducing the risk (and dealer participation) to retailers. There is also some indication that the abolition of holder in due course defenses and waiver of defenses tend to result in *lower* finance rates to the customer. Although this result appears to be somewhat contradictory, it is possible that finance companies impose more stringent quality standards and charge less when such creditors' remedies are abolished. This explanation is reinforced by the fact that rate ceilings in some states prevent any substantial increases in rates when such creditors' remedies are abolished.

The negative relationship between finance rates and the abolition of the aforementioned creditors' remedies is also found in the case of retail credit supplied indirectly by commercial banks. In this case, however, there is little indication that legal rate ceilings have an overall restrictive effect on finance rates. Thus, it is quite possible that banks tend to purchase the higher quality sales finance contracts. As expected, finance rates also appear to be positively associated with bank operating costs and cost of funds. In addition, higher levels of bank growth, an indication of an environment conducive to competition, is associated with lower rates. However, higher levels of bank concentration are associated with higher rates, suggesting that there is a range of com-

petitive and noncompetitive conditions among the states.

In the analysis of retail-originated credit, the individual amounts of OCG credit supplied by retailers, banks, and finance companies were grouped as one collective source. The econometric analyses indicate that *lower levels of retail sales financing, relative to total OCG sales*, are associated with *higher market concentration* in the retailer and finance company sectors. As illustrated in Exhibit 7-10, the average level of retailer concentration (51 percent) in a sample of 12 states with the highest average percentage of retail sales financing is substantially lower than the average level of 67 percent for retailer concentration in a sample of states with the lowest average percentage of retail sales financing. A similar correlation is seen in the case of finance company concentration. The econometric analyses indicate that these relationships are statistically significant even when credit demand factors such as aggregate income, urbanization and age composition of the population are taken into consideration. The econometric analyses indicate that high levels of market concentration among the bank suppliers of indirect credit are positively associated with higher levels of retail financing, although no such indication is present in the simple comparisons of Exhibit 7-10. This contradiction with the apparent effects of retailer and finance company concentration, however, is consistent with observations of credit availability in the new automobile credit market, where high levels of bank concentration are associated with lower levels of direct loans at banks but positively associated with higher levels of financing at automobile dealers. Again, these observations are consistent with the expected behavior of firms in imperfectly competitive markets.

The econometric analyses also indicate that the abolition of holder in due course defenses and waiver of defenses results in lower credit availability from finance companies and retailers directly, although the supply of indirect bank credit is not affected. Of the seven states that have abolished both defenses, Hawaii, Massachusetts, New York and Vermont are in the group of states with the lowest average availability; Utah and Washington are in the group of states with average availability (Arkansas was deleted from the analysis because of questionable data). Although the apparent restrictive effect on retailer-held credit is paradoxical since these remedies are not applicable to direct sup-

EXHIBIT 7-10

Market Concentration and the Percent of Total Other Consumer Goods Sales Financed Through Retailers

	Average of 12 States with Highest Percent of Retailer Financing[a]	Average of 12 States with Lowest Percent of Retailer Financing[b]
Percent of Total OCG Sales Financed at Retailers	20.8	10.8
Retailer Concentration[c]	51.3	67.1
Bank Indirect Concentration[c]	46.3	47.4
Finance Company Concentration[c]	54.3	63.5
Rate Ceiling for $800, 24 months retail sales financing	20.15[d]	20.14[e]

(a) States included: Missouri, Nevada, Mississippi, Oregon, Indiana, Virginia, Iowa, Tennessee, South Carolina, Georgia, Minnesota, Texas

(b) States included: Arizona, Hawaii, Vermont, Delaware, Colorado, Illinois, California, New York, Connecticut, Massachusetts, New Jersey, New Hampshire

States dropped from consideration because of disclosure restrictions or questionable data: Alaska, Arkansas, Kansas, Kentucky, Louisiana, Maine, Montana, North Carolina, North Dakota, Oklahoma, Rhode Island, South Dakota, West Virginia, Wyoming, District of Columbia

(c) Four-firm concentration ratio (percent)

(d) Six states with no legal rate ceiling not included in the average

(e) Three states with no legal rate ceiling not included in the average

Source: National Commission on Consumer Finance Survey of Consumer Credit Volume, Second Calendar Quarter, 1971, and Consumer Credit Outstanding, June 30, 1971.

pliers of credit, it is quite possible that any restrictive effect arises from the inability of retailers to sell the lower quality sales finance contracts and their unwillingness or inability to hold the contracts themselves. This proposition is explored in greater detail in the discussion of creditors' remedies in Chapter 3.

Conclusions on the OCG Credit Market

The Commission's studies indicate the presence of some credit rationing in the bank direct loan market and in the retail-originated instalment credit market supplied by retailers and finance companies. In view of the overall importance of retailer-supplied credit, the credit rationing is more substantial in that market segment. Since legal rate ceilings in some states have a restrictive effect on the finance rates on finance company credit, and possibly on that of retailer-held credit, the credit rationing is primarily of a nonprice nature. That is, suppliers apparently restrict supply to accommodate the better credit risks rather than increase finance rates to serve higher credit risks. In addition, there is some indication that reduced availability of OCG credit is associated with the abolition of creditors' remedies.

The Personal Loan Market

The Commission's study of the personal loan market involved the analysis of rates of charge and availability of personal loans from three main sources: banks, finance companies and credit unions. As with the other credit markets, this discussion begins with an analysis of market structure and then proceeds to review the research findings on the price and availability of personal loans.

Market Structure

Since the personal loan market by definition consists entirely of direct cash lending, the analysis of market structure is simplified by the absence of indirect credit and the complications associated with retailer-established credit prices. Thus, there is no opportunity for the price of credit to be included in the price of goods sold, although some portion of the finance charge may be included in the premium for credit insurance. The potential borrower has three main alternative sources: banks, credit unions (if he or she is a member) and finance companies.

It is generally acknowledged that there is some gradation in the risk classification of borrowers typically served by the various institutional sources. Since rates paid for credit should be related to the credit risk of the borrower, some measure of risk gradation is obtained by a preliminary review of the typical rates at various sources. Based on the average of state responses for the institutional average price of personal loan credit within each state, the following institutional ranking of rates (from low to high) is observed:

Average of State Responses[12]

Credit Unions	11.76%	(All personal loans)
Mutual Savings Banks	12.44%	($1000, 12 months unsecured instalment loans)
Commercial Banks	13.04%	($1000, 12 months unsecured instalment loans)
Finance Companies	25.88%	(All personal loans; average of state-average loan sizes = $979)

Although variations in average loan size distort this comparison to some extent it is reasonable to assume that borrowers at finance companies are likely to be in a higher risk category than borrowers at the other institutions and will pay a correspondingly higher rate for the credit service. Risk gradations may be explained by two basic factors: legal constraints and industry practice. The primary legal constraint placed on banks and credit unions in some states is the legal rate ceiling. It is easy to see that a low rate ceiling will limit the number of borrowers who qualify (on a risk basis) for credit at that price. Unqualified borrowers must then seek alternative sources. To put the matter in historical perspective, it is recalled that state personal loan legislation has generally been enacted to set higher rate ceilings for certain institutions, notably finance companies, and to supervise closely their lending activities. Thus, finance companies can generally serve some borrowers who cannot be served under the rate ceilings governing other institutional sources of credit. Potential borrowers who cannot be served by finance companies must either forego credit or seek a source which provides credit at even higher prices—pawn shops and illegal lenders, for example. Thus, it is clear that diverse legal rate ceilings tend to promote market segmentation on the basis of risk. It is also clear that inter-institutional differences in the kinds of permissible creditors' remedies will promote risk gradation in the same manner.

The "industry practice" explanation for risk gradation implies that some credit institutions may find it convenient to shape their operations to attract borrowers within a portion of the risk spectrum of all borrowers. According to this premise, banks consider themselves to be low-rate lenders, while finance companies cover the upper spectrum of credit rates. The Commission finds some support for this viewpoint in the

comparison of bank personal loan rate ceilings and the corresponding reported rates of charge. In states where the bank rate ceiling is relatively high or nonexistent, the average reported bank rate is still in many cases considerably below the average rate at finance companies. In this case it can be inferred that accepted bank customers are better credit risks than those borrowing at finance companies. While such specialization of operations may result in some cost efficiencies, one other result of such behavior is a reduction of intersource competition between low rate and higher-rate lenders. However, this latter result is less serious if there exists substantial cost efficiencies from such behavior *and* if there is active *intrasource* competition.

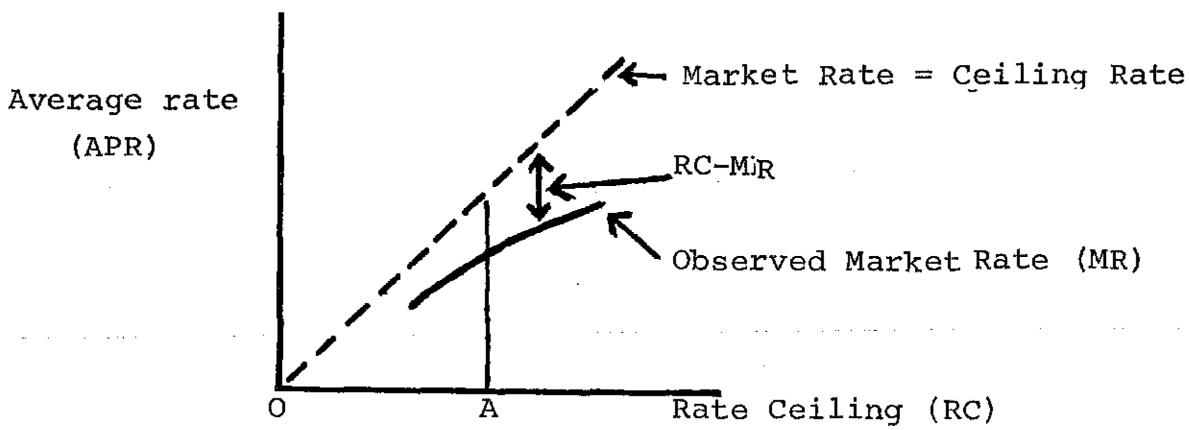
It should be noted that intersource variations in rates are also introduced by legal limitations on the size of loans granted by certain lenders in some states. This is typically the case in the finance company sector. Since studies of bank and finance companies indicate that costs increase as loan size increases, but less than proportionally, it follows that small loans cost more *per dollar* of loan.[13] Thus, rates charged for finance company personal loans are commonly graduated on the basis of loan size, with a higher rate charged for smaller loans. Banks, on the other hand, tend to graduate rates only by type of loan, with average rate levels reflecting average loan size and, perhaps, collateral. Accordingly, under *ceteris paribus* conditions, an institution which operates under restrictive loan size limits can be expected to have higher average rates of charge than an institution which is able to make larger loans.

Rates of Charge and Availability

Finance Companies. The econometric models developed in staff studies on the personal loan market show that rates charged for personal loans at finance companies are influenced by a complex set of factors involving rate ceilings, market concentration, barriers to entry, growth rate of finance company offices and creditors' remedies. Because of the complexity of the economic theory underlying the models, only a summary of the research is presented here; a detailed analysis is properly reserved for supporting staff research reports.

Since it is common belief that rates charged for personal loans at finance companies are likely to be at, or near, the legal rate ceiling, the analysis of rate behavior focused on the difference between the average rate ceiling and the average observed rate in each state.[14] It was expected that the spread between the ceiling and market rates would increase as the rate ceiling increased, because higher ceilings are less likely to be restrictive. This simple proposition is illustrated in the following diagram:

Figure 6



This hypothesized relationship between the average rate ceiling (computed over $100 loan size intervals) and the observed average rate of interest was tested on two subsamples of states using two alternative estimates of observed average rate. One subsample consisted of 24 states with the lowest average rate ceilings, and the second sample consisted of the complementary group of 24 states with the highest average rate ceilings. (Alaska, the District of Columbia, and Hawaii were deleted because of missing data.) The two averages of rates for each state differed only in the weighting procedures used to calculate the averages from a sample of loan contracts collected during the last two weeks of June, 1971. By one technique the average market rate was calculated by weighting the APR for each contract by the dollar amount of the contract, resulting in an average rate charged for each *dollar* borrowed. The alternative average rate was a simple, unweighted aver-

age, which represents the average rate per *contract* in each state.

As one would expect, both of these observed average rates were very closely related to the average rate ceiling for the low-ceiling subsample of states. Indeed, nearly 80 percent of the variance in the observed weighted average rate is accounted for by variations in the rate ceiling. As the rate ceiling rises, both observed rates rise, but by less than equivalent amounts. A one percentage point rise in rate ceiling is associated with a .8 percentage point rise in both of the average rates. Thus the relationship is close to a one-to-one relationship, although also suggesting that the absolute percentage point spread between the observed mean rates and the mean ceiling grows as the ceiling rises. The behavior of observed market price is shown in the low-ceiling portion of the range between points O and A on the horizontal axis of Figure 6 above.

For the high-ceiling subsample of states, variation in the average rate ceiling accounted for only about 11 percent of the total variance in the observed market average rates, whether weighted or unweighted. With varying degrees of statistical significance, it is apparent that market rates are relatively low in comparison to the ceiling where real family income is relatively high and average loan size is relatively large. Conversely, it appears that where garnishment is restricted or prohibited, the observed rates are somewhat higher than would otherwise be the case.

The influences of growth and competitive circumstances are less clear because the two alternative measures of average observed interest rate yield differing results. On average, increases in finance company concentration ratios are associated with lower average APR's because fewer loans are granted (presumably to better credit risks). On the other hand, higher growth rates of finance companies are associated with a greater amount of credit granted, but not with a significant difference in APR's. But the two associations are interrelated. With reference to the unweighted average APR, the interactive effect of concentration and growth suggests that concentration raises the rate where growth is relatively slow. This result is in accord with economic theory: rapid growth of market demand is expected to foster competitive behavior under most common conditions because newly entering firms have greater chances of success and also because the rivalry among established firms is typically more intense when a large portion of their business is "new" to the market as opposed to "repeat" business. Conversely, slow or negative market growth naturally discourages the entry of newcomers and the opportunities for market share expansion among the established firms are substantially curtailed, both of which stifle procompetitive incentives.

One possible explanation for the inconclusive results regarding competition and rates may be that lenders can exercise market power when they possess it either by raising their prices or by limiting their extensions of credit to include only relatively low-risk borrowers, or both. The latter type of behavior can be called "quality credit rationing," and the purpose of both practices would be to enhance profits. It is important to recognize that "quality rationing" may be utilized instead of price variations as a substitute means of maximizing profits where price increases are not possible (because of law) or not feasible (because of, say, damand conditions). The Commission's evidence concerning the availability of personal loans at finance companies suggests the presence of just such behavior.

The analysis of availability in this segment of the market was based on three alternative measures of "availability:" the number of loans supplied per family; the dollar value of loans supplied per family; and the difference between the number of loans demanded and the number of loans supplied as measured by the proportion of loan applicants denied credit.

Since demand generally exceeds supply in this market segment, it can be reasonably assumed that increased number and amounts of loans per family will typically indicate increased "availability" relative to demand. Conceptually, the last measure of availability which may be called the "rejection rate" is an index of "quality credit rationing." It also measures differences in the extent to which supply falls short of demand and is therefore "unavailable." To obtain accurate and meaningful data concerning rationing or rejections is very difficult[15] because of varying definitions of what constitutes an "application" and a "rejection". Moreover, demand as measured by applications is not necessarily independent of rejections policy since, over the long run, severely restricted availability may curb applications of many potential borrowers.

As measured by the average number of loans per household extended during the second quarter of 1971, it was found that, across states, availability of finance company personal loans was relatively greater where unemployment, concentration, and labor costs of finance company employees were relatively low, and where rate ceilings, growth, real income, and the intrastate variance of personal loan interest rates were relatively high. The prohibition of garnishment and, to a lesser degree, wage assignments also seems to have reduced the number of loans supplied. Very similar findings were obtained with respect to the dollar amounts of credit supplied by finance companies, except that in this case the tight administration of Convenience

and Advantage (C&A) licensing was additionally associated with reduced availability and wage assignments had no discernable effect.

Interstate variations in the rejection rate of loan applications are much more difficult to explain because of certain complexities in the behavior of this measure. But for present purposes it will suffice to demonstrate in a simplified way the influence of a few key factors upon this measure—legal rate ceilings, concentration, and C&A licensing. At the same time it can be shown that the three alternative measures of "availability" correspond closely with each other, providing a welcome consistency of results.

Exhibit 7-11A presents data on the number and value of loans extended by finance companies during the second quarter of 1971, the estimated percentage of loan applications rejected during the same period, four-firm concentration ratios, the mean rate ceiling, and the rate ceiling on a $500 loan for a selected group of eight states which are among those with lowest average legal rate ceilings. In contrast, Exhibit 7-11B presents comparable data for eight states which have some of the highest legal rate ceilings as measured on an average ($100 interval) basis. Within each rate ceiling group, the states are further distinguished by the type of C&A regulation: those where C&A are tightly administered being segregated from those where C&A pose no barrier to the entry of new firms or branch offices.

Comparison of the overall averages of the two tables suggests that availability is substantially restricted in states where rate ceilings are low and concentration is high. The average rejection rate for the low ceiling states

EXHIBIT 7-11A

Low Rate Ceilings Finance Companies

C & A Other

State	(1) $/FAM	(2) #/FAM	(3) Rejection Rate (%)	(4) Conc. Ratio	(5) Rate Ceiling Mean $100 Int.	(6) Rate Ceiling $500 Limit
Missouri	43.84	.0419	32.33	41.2	18.13	26.62
Tennessee	38.19	.0432	32.46	45.0	25.16	27.29
Mean	41.02	.0426	32.40	43.1	21.65	26.96
C & A Tight						
Arkansas	12.03	.0092	99.99*	85.5	10.00	10.00
Connecticut	39.49	.0370	41.85	47.4	24.32	25.94
Maine	15.63	.0180	31.24	63.3	24.56	27.66
Massachusetts	31.27	.0283	28.75	58.9	22.73	27.58
New Jersey	32.88	.0437	38.48	50.7	23.83	24.00
New York	23.49	.0237	35.05	75.2	23.83	24.82
Mean	25.80	.0267	45.89	63.5	21.55	23.33
Overall Average	29.61	.0306	42.52	58.4	21.58	24.24

*There were no offices in Arkansas for the three companies supplying rejections data.

Source: Columns 1, 2, and 4 are data from the Commission's Survey of Consumer Credit Volume, Second Quarter, 1971, and Consumer Credit Outstanding, June 30, 1971. The data for column 3 are calculated from data supplied to the Commission by three large finance companies for the 2nd quarter of 1971 or the month of June 1971. Current borrowers applying for extensions or increases in their outstanding loans were excluded from the applications-rejections computations. Columns 5 and 6 are from C. H. Gushee, *Cost of Personal Borrowing in the United States,* 1971 Edition (Boston: Financial Publishing Co., 1971) and refer to ceilings under the states' small loan laws.

of Exhibit 7-11A is 43 percent compared with an average of only 28 percent for the high ceiling states. As measured by loan extensions per family, availability in the low ceiling states is less than half of that in the high ceiling states: $29.61 and .0306 on a dollars and numbers per family basis, respectively, compared with $72.87 and .0733. Market concentration in the low ceiling states is much greater than concentration in the high ceiling states—58.4 versus 39.9 percent for the top four firms.

These differences may in part be attributable to concentration since, in a low rate ceiling situation, firms with market power can engage in more quality rationing of borrowers to reduce costs and improve profits. On the other hand, the ultimate cause of low availability even in such a case could be low rate ceilings because they can create concentration by forcing small, marginal companies out of business leaving larger, and possibly more efficient, chain companies with a greater share of the market but not necessarily greater than normal profits.

The combined effect of high concentration and entry barriers may be seen in Exhibit 7-11A by comparing the average availability measures of (1) low ceiling states which have no tight C&A entry barriers and also have relatively low concentration with (2) low ceiling states in which C&A is tightly administered and concentration is relatively high. Although the mean ceiling is about the same for both groups of low ceiling states (21.65 and 21.55), average dollars per family is 41.02 compared with 25.80, average numbers of loans per family is .0426 compared with .0267, and the average rejection rate is 32.4 percent compared with 45.9 percent. Economic theory provides explanation for this behavior: high concentration and barriers to entry are both necessary conditions for the exercise of market power, but separately neither one alone is a sufficient condition for the exercise of that power. Where rate ceilings are low, such market power cannot be expressed in higher prices, but, given the right of refusal to sell, it can be expressed in "quality rationing" as a means of substantially

EXHIBIT 7-11B

High Rate Ceilings Finance Companies

State	$/FAM	#/FAM	Rejection Rate (%)	Conc. Ratio	Rate Ceiling Mean $100 Int.	Rate Ceiling $500 Limit
C & A Other						
Alabama	54.88	.1200	32.65	31.8	35.42	24.92
Hawaii	183.98	.0834	21.51	41.3	42.58	24.25
Indiana	68.77	.0592	35.23	48.8	32.85	33.49
Maryland	65.81	.0708	30.34	49.5	35.31	33.61
West Virginia	58.62	.0683	27.38	36.7	32.19	31.14
Mean	86.41	.0804	29.42	41.6	35.67	29.48
C & A Tight						
Florida	40.39	.0659	22.93	25.9	35.32	34.08
Idaho	56.05	.0672	26.45	43.4	32.11	33.61
Kentucky	54.52	.0516	31.35	41.7	31.77	33.61
Mean	50.32	.0616	26.91	37.0	33.07	33.77
Overall Average	72.87	.0733	28.48	39.9	34.69	31.09

Sources: See notes to Exhibit 7-11A.

reducing costs of risk for purposes of augmenting profits.

Concentration thus has observable adverse effects on supply, but legal rate ceilings seem a more important determinant when they are especially low. For the 24 lowest average rate ceiling states referred to earlier, market growth and rate ceilings alone accounted for 62 and 70 percent of the respective variance in dollar and number supply per family. Since the median average rate ceiling for all states was 27.8 percent APR, this means that average rate ceilings lower than about 28 percent appear to restrict credit availability directly and substantially, regardless of whatever influence other variables may have. Moreover, in testing for a relationship such as outlined in Figure 5 of the introduction, there is evidence that the greatest supply of credit (the maximum quantity in Figure 5) is obtained from an average rate ceiling of 28 to 30 percent APR. This range represents the closest approximation to the point Pc, Qc in Figure 5, where the rate ceiling sets a rate which maximizes the availability of credit to borrowers. In short, it establishes a rate ceiling low enough to prevent higher rates based upon market power without restricting the supply of loans. Although this suggests that an average ceiling in excess of 30 percent will actually reduce the availability of credit, other factors (such as unemployment, concentration growth, and real income) are more important as determinants of supply where rate ceilings are high. So little confidence can be attached to proposals to lower rate ceilings below the 28-30 percent average APR if they are recommended to "maximize" credit availability to consumers.

Commercial Banks and Mutual Savings Banks. A summary of staff findings concerning rate of charge in this segment of the personal loan market can focus on just a few key variables. Excluded from consideration here are such potentially important policy variables as the stringency of entry regulations and restrictions on creditors' remedies. Although these and similar items may affect the performance of the banking sector in serving the public, the analysis was frustrated by one of two circumstances: (1) an absence of interstate variation in these matters—e.g., national chartering of banks provides a regulatory entry option uniformly accessible to newcomers in all states—or (2) the presence of measurable variance, but, as with creditors' remedies, search for significant effects found nothing of importance.[16] Indeed, most of the "nonpolicy" variables used in attempts to explain price variations (such as real income, average size of bank office, and the like) also did not appear to be significant determinants of observed bank personal loan rates. The only factors which seemed of notable consequence were legal rate ceilings, growth, and (less significantly) market concentration. To take one example from the cross-state analysis, the observed average APR for commercial bank $1,000 unsecured personal loans was negatively associated with bank growth and positively associated with the legal rate ceiling on such loans and with market concentration.

Measures of availability for this segment of the market are limited to per capita quantities supplied in terms of either dollars or numbers because rejection rates or other measures of "quality credit rationing" are unavailable for this institutional class of lenders. Nevertheless, since demand in this segment seems generally to exceed supply,[17] so it can again be reasonably assumed that increased absolute quantities supplied per family will be indicative of greater availability.

Exhibits 7-12A and 7-12B show both the number and dollar amounts of personal loan credit extended by commercial banks and mutual savings banks (combined) for two separate groups of selected states—16 with relatively low rate ceilings on unsecured personal loans (Exhibit 7-12A), and 16 with relatively high ceilings (Exhibit 7-12B). It can be seen that the overall average of availability of credit in the low ceiling states is substantially below that of the high ceiling states. In terms of number of loans per family, the average of the former is .0366 compared with .0453 for the latter. In dollars it is $37.02 versus $44.82. Since the differences in overall concentration and growth between the two groups are slight (see the base figures of columns (3) and (4)), it appears that relatively low legal rate ceilings may adversely affect availability in the bank personal loan market as they did in the finance company market.

Although the average concentration ratio appears to be related to availability measured by the number and amount of loans per family within each of the two ceiling subgroups above and below the group medians, staff econometric studies offered only moderate supporting evidence that market power limited the availability of commercial bank personal loans. The averages in Tables 7-12A and 7-12B are not truly representative since the range of observations is large. On balance, it would seem that differences in market concentration may affect availability in some states, but not pervasively in all states.

Credit Unions. Credit union rates and quantities supplied seem to have little or no impact on the performance of banks and finance companies in this market. A slight but significant reverse influence can be observed, however. There is some evidence that banks and finance companies do lose customers to credit unions, but the cross-substitution is not great. Low rate ceilings possibly prevent credit unions from competing with finance companies for higher risk customers while restrictions on membership force them to limit their

EXHIBIT 7-12A

Bank Personal Loans Low Ceiling States

Below Median

States	(1) Number of Loans per Family	(2) Dollars of Loans per Family	(3) Concentration Ratio	(4) Bank Growth[a]	(5) Rate Ceiling $1000 Unsecured Loan
Washington	.0159	24.14	63.9	229	12.00
Maryland	.0208	31.34	49.4	231	12.00
Iowa	.0239	15.86	10.5	220	12.00
Idaho	.0258	23.72	89.3	216	11.58
New Jersey	.0293	46.65	18.9	215	11.58
Minnesota	.0329	28.02	19.1	229	11.58
Vermont	.0338	34.63	51.8	218	11.58
North Dakota	.0358	22.38	8.5	223	11.58
Mean	.0242	28.34	38.9	223	11.74
Above Median					
Arkansas	.0369	20.70	16.4	247	10.00
South Carolina	.0422	34.07	53.9	244	12.68
Pennsylvania	.0422	66.09	19.2	212	11.58
New York	.0472	74.73	34.2	218	11.58
Alabama	.0515	39.02	25.0	244	10.90
Tennessee	.0542	38.55	18.6	237	11.58
West Virginia	.0548	43.53	13.6	235	11.58
Georgia	.0629	48.80	24.1	270	10.90
Mean	.0490	45.69	25.6	238	11.35
Overall Average	.0366	37.02	32.3	231	11.55

[a] Total bank assets in state, year-end, 1971 divided by total bank assets in state, year-end, 1961.

EXHIBIT 7-12B

Bank Personal Loans High Ceiling States

Below Median

State	(1) Number of Loans per Family	(2) Dollars of Loans per Family	(3) Concentration Ratio	(4) Bank Growth[a]	(5) Rate Ceiling $1000 Unsecured Loan
California	.0185	26.74	54.5	218	None
Ohio	.0209	28.16	27.6	203	None
Rhode Island	.0294	47.85	90.0	188	21.00
Colorado	.0320	40.54	15.7	229	None
Utah	.0362	30.11	63.1	193	28.64
Arizona	.0364	50.79	91.7	289	27.55
Massachusetts	.0379	54.28	15.4	222	25.39
Kansas	.0401	25.80	12.1	216	22.40
Mean	.0314	38.03	46.3	220	- -

Above Median

State	(1) Number of Loans per Family	(2) Dollars of Loans per Family	(3) Concentration Ratio	(4) Bank Growth[a]	(5) Rate Ceiling $1000 Unsecured Loan
Connecticut	.0448	67.59	36.7	227	None
Texas	.0478	38.55	12.0	230	19.72
New Hampshire	.0493	50.46	19.6	261	None
Wyoming	.0560	42.08	32.3	199	23.61
New Mexico	.0620	41.54	44.6	222	22.10
Oklahoma	.0644	42.52	17.1	217	25.24
Louisiana	.0693	49.48	16.5	230	None
Maine	.0789	80.59	28.2	205	None
Mean	.0591	51.60	25.9	224	- -
Overall Average	.0453	44.82	36.1	222	

[a] Total bank assets in state, year-end, 1971 divided by total bank assets in state, year-end, 1961.

495-072 O - 73 - 11

lending to segments of the community with a "common bond." The interstate uniformity of rate ceilings prevented an analysis of the relationship of rate ceilings and availability of credit among credit unions.

One finding concerning credit union personal loan availability is that restrictions on the use of wage assignments, or the prohibition thereof, appear to reduce the number and amount of credit union personal loans. Of the several creditor remedies tested in this context, wage assignments seem to be the only remedy of importance, perhaps because these and wage deductions, which are similar though not exactly the same, are heavily relied on by credit unions as convenient and low cost collection techniques.

Conclusions on the Personal Loan Market

The implications of the foregoing can be readily summarized. Legal rate ceilings may reduce the price of personal loan credit to some borrowers, but when ceilings are sufficiently low to affect the observed market rate in a significant way, there is a substantial reduction in the number of borrowers included in the legal market. Relatively low risk borrowers who remain in the legal lending market appear to benefit from the lower cost loans made when higher risk potential borrowers are excluded.

There is no such trade-off when it comes to the impact of competition. When concentration, growth, and C&A limits on entry are all present, lenders may be able to exercise market powers either to raise price or to limit the availability of credit to marginal borrowers, or both. The price effect may, of course, be attributable to the direct positive tie which price has with profits (up to a limit). Profits are also inversely related to costs, everything else being equal, and it is presumably for this reason that noncompetitive market structures are associated with limitations of credit supply. It has been emphasized that credit sources may limit the markets they serve either by raising rates of charge or by raising their standards of creditworthiness among the applicants they accept. This latter policy option of adjusting the cut-off point between accepted and rejected loan applications has been stressed because rate ceilings offer little leeway for rate increases in the finance company portion of the personal loan market.

The implications of these findings for public policy seem obvious: the only truly effective way of gaining ample supplies of personal loan credit for consumers *and* reasonable rates too, is to increase competition while simultaneously relaxing inordinately restrictive rate ceilings.

In testing the extent to which variations in the strength of creditors' remedies influence personal loan credit availability, three types of remedies were included in the analysis—garnishment, wage assignments, and confessions of judgment. Although the supply of commercial bank personal loans appears immune to differences in the legal status of these remedies, the analysis indicates the presence of direct relationship between the supply of finance company loans and the ease with which garnishment may be utilized in the collection process. Differing laws concerning wage assignments are significantly associated with differing credit availability only in the case of credit unions,[18] though there is weak evidence that the number of finance company personal loans is also lower where wage assignments are prohibited.

COMPETITION: CONCLUSIONS AND RECOMMENDATIONS

In light of the foregoing analysis it is easy to conclude that performance in many consumer credit markets is not satisfactory. As suggested in this chapter's introduction, substantial improvements are well within reach if reasonable changes affecting competition and rate ceilings are implemented.

Conclusions

There is ample evidence indicating that competition is impaired in a number of states by a variety of conditions affecting all of the major types of consumer credit. A common structural condition of these markets is that they tend to be highly concentrated and difficult for newcomers to enter because of relatively slow growth in demand for credit, or legal restrictions on entry, or some other impediment or combination thereof. By comparison many other state markets appear to be fairly competitive, a judgment which is indicated not only by the existence of contrasting structural conditions but also by related measures of better performance.

Commission recommendations may be grouped under five general headings—rate ceilings, entry conditions, mergers, market restructuring, and restrictive agreements. Each will be treated in turn.

Rate Ceiling Policy

The subsequent recommendation concerning the liberalization of legal interest rate ceilings on consumer loans in many states is grounded on considerations which go beyond the direct adverse effects that low ceilings appear to have on credit availability, for the present level and structure of legal rate ceilings in most states appears to stifle competition in several ways. In the first place, Commission staff found that the simple

correlation coefficient between finance company concentration ratios in the personal loan market and the average level of personal loan (average) legal rate ceilings is −.48 for all of the 47 states included in the analysis and −.49 for states with rate ceilings below the median. This implies that within this institutional class of lenders high concentration may in part be the *product* of especially low legal rate ceilings. It is not certain exactly why low rate ceilings appear to foster concentration, but it is reasonable to speculate that they make it more difficult for new firms to compete with established firms by restricting their opportunity to achieve the volume of business needed for efficient utilization of office space and personnel during a customary "break-in" period. Also, low rate ceilings impose upon existing lenders a uniformity of risk acceptance and operations policy that otherwise need not be sustained. Thus, low rate ceilings can adversely limit the alternatives for borrowers by standardizing the market organization of lenders of a given type. In addition, low and moderate rate ceilings probably offer lenders convenient focal points for purposes of tacitly setting uniform rates, a readily understandable form of pricing behavior that is likely to lead to more uniform rates of charge among companies and, under certain circumstances, higher rates than otherwise would be possible.[19]

Just as the level of rate ceilings may affect intra-institutional competition, so too can the structure of rate ceilings (as they apply to different credit sources) affect inter-institutional competition. When, for example, the ceiling applicable to a given type of credit for one class of lenders is substantially below that of another class of lenders, the former class will be forced to serve mainly low risk borrowers the latter, high-ceiling class will tend to serve relatively higher risk borrowers. This artificial segmentation of the market obviously, restricts inter-institutional rivalry.

Entry Conditions

Of all the recommendations concerning competition policy the most basic is to permit freer entry.[20] With respect to new commercial bank entry, there has been in the past an excessive concern on the part of chartering and regulatory authorities for the protection of the profitability of existing bank institutions and the presumed "needs and convenience" of the public. Too little emphasis has been given to the vigor of bank competition and relying on such competition to provide optimal performance in terms of price and availability. The economics of entry have been summarized by Donald Jacobs:

> If the rate of return is low in an area, no new bank will seek to enter. Restrictions on entry in these cases are redundant. In areas where the rate of return on capital is high, entry restrictions may impede the free flow of new capital. At best, the economic effects of entry restrictions are redundant; at worst, they are harmful.[21]

The presence of deposit insurance will continue to protect depositors' funds and current supervisory standards will continue to preserve the safety and soundness of commercial banks in an environment where there is liberalized entry chartering and more vigorous competition.

Bank branching regulations are also important in this connection. Although it can be argued that full statewide branching allows the greatest freedom to banks for market extension or branch entry, it can also be argued that statewide branching, especially when coupled with high concentration, is the most detrimental of branching policies with respect to new bank entry.[22] Besides the possibility of pre-emptive branching on the part of established banks within a state, statewide branching appears generally to reduce the number of independent banks operating in a state and consequently to foster concentration. This serves to restrict the number of established banks which might offer correspondent services in assistance to newly formed banks.[23] Although *the Commission makes no generally applicable recommendation concerning branch banking, because conditions can vary among the states, it does recommend that where statewide branching is allowed, specific steps be taken to assure easy new entry and low concentration. Such steps would include:*

1. *Giving preferential treatment wherever possible to charter applications of newly forming banks as opposed to branch applications of dominant established banks;*
2. *Favoring branching, especially the* de novo *branching, whether directly or through the holding company device when such branching promotes competition. However, banking regulators should exercise a high degree of caution in permitting statewide branching whether directly or through the holding company device when such branching decreases competition or increases economic concentration;*
3. *Encouraging established banks and regulatory agencies to see that correspondent bank services be made available (for a reasonable fee) to assist newly entering independent banks, including the provision of loan participation agreements when needed;*
4. *Disallowing regional expansion by means of merger and holding company acquisitions when such acquisitions impair competition; recognizing*

that statewide measures of competition are relevant.

In conjunction with the foregoing *the Commission recommends, as did the President's Commission on Financial Structure and Regulation, that under prescribed conditions savings and loan associations and mutual savings banks be allowed to make secured and unsecured consumer loans up to amounts not to aggregate in excess of 10 percent of total assets.*[24] These lending activities should be subject to the same examination and supervisory procedures applied to licensed finance companies.

With respect to regulations restricting entry of finance companies in the market, the Commission finds no value in "Convenience and Advantage" limitations on entry. There is ample evidence indicating that these and similar restrictions are disadvantageous to the public and should be abolished. *The Commission recommends that the only criterion for entry (license) in the finance company segment of the consumer credit market be good character, and that the right to market entry not be based on any minimum capital requirements or convenience and advantage regulations.*

Inter-institutional competition can also be encouraged (in a somewhat different way) by permitting commercial banks direct access to the relatively high risk segment of the personal loan market currently dominated by finance companies. *The Commission recommends that direct bank entry in the relatively high risk segment of the personal loan market be made feasible by:*

(1) *Permitting banks to make small loans under the rate structure permitted for finance companies*;

(2) *Encouraging banks to establish* de novo *small loan offices as subsidiary or affiliated separate corporate entities. Regardless of corporate structure, these small loan offices, whether separate or within other bank offices, should be subject to the same examination and supervisory procedures applied to other licensed finance companies*;

(3) *Exempting consumer loans from the current requirement that bank loan production offices obtain approval for each loan from the bank's main office;* and

(4) *Prohibiting the acquisition of finance companies by banks when banks are permitted to establish* de novo *small loan offices.*

Mergers

In view of evidence in this chapter indicating the adverse effects of concentration on credit market performance, *the Commission recommends that existing regulatory agencies disallow mergers or stock acquisitions among any financial institutions whenever the result is a substantial increase in concentration in state or local markets.* Where regulatory agencies fail in this respect, the Commission encourages the intervention of the Antitrust Division of the Department of Justice to enforce the Federal merger status. Past actions under the Bank Merger Acts of 1960 and 1966 have been somewhat successful in curbing increases in concentration[25] so no new legislation is proposed at this time. But the Commission stresses the need for continued vigilance.

The Commission recommends that inter-institutional acquisitions be generally discouraged even though there is no effect on intra-institutional concentration. Bank holding companies' acquisitions of finance companies, for example, eliminate the acquiring banks as potential direct competitors of small loan companies. In recent years policies with respect to branch banking of bank holding company acquisitions have been considerably liberalized. The Commission believes the easiest way to prevent increased market concentration from following this trend is to apply rigorous competitive standards to all bank acquisitions.

Restructuring Concentrated Markets

The foregoing recommendations will go a long way toward improving the competitive climate in most state and local markets. But in some cases these structural measures may not be sufficient to restore competition or to achieve significant entry, except perhaps in the very long run. For this reason, *the Commission recommends that state regulatory agencies and legislatures review the market organization of their respective financial industries after a 10-year trial period of earnest implementation of recommendations on market entry and concentration. If, despite these procompetitive efforts, such review discloses inadequate competition—as indicated, say, by continued market dominance by a few commercial banks and finance companies or the absence of more frequent market entries—then a restructuring of the industry by dissolution and divestiture would probably be appropriate and beneficial.*

Restrictive Arrangements

Although almost obvious, the Commission recommends that antitrust policy, both Federal and state, be alert to restrictive arrangements in the credit industry. Any hint of agreement among lenders as to rates, discounts, territorial allocations, and the like must be vigorously pursued and eliminated. Furthermore, such antitrust policy should not be exclusive to the Attorneys General explicitly charged with enforcement, but should

be the underlying principle of the regulatory agencies administering various aspects of the consumer credit market, e.g., the FRB, FDIC, state banking agencies, etc. Although, of course, some cooperative endeavors are essential to industry operation—e.g., correspondent relationships, credit bureaus, and lenders' exchanges—these should not be allowed to mask unnecessary or unreasonable restraints, nor should agreements with no purpose other than to restrain competition be allowed to stand.

COST FACTORS INVOLVED IN DETERMINING RATES AND RATE CEILINGS

The staff's empirical evidence cited in preceding sections indicated that relatively low rate ceilings—ceilings which actually influence the observed rate—are typically associated with significant reductions of credit supply in affected state markets. In the finance company segment of the personal loan market, for example, it was estimated that supply per family began to fall where rate ceilings averaged between 28 and 30 percent. Below an average ceiling rate of about 28 percent, between 60 and 70 percent of the interstate variation in supply is accounted for by rate ceiling variations and growth. Similarly, supplies of revolving credit per family are apparently below the national average where APR's on revolving accounts are less than 18 percent. As explained earlier, such curtailments may be expected to occur whenever rate ceilings impose a price insufficient to cover the costs of extending credit. This is, of course, a fundamental proposition that applies to the production and sale of any service or commodity: if the price is not sufficient to offset costs, including normal costs of capital invested, supply is curtailed unless subsidies in some form are provided. Therefore, it is necessary to explore carefully the costs incurred in extending credit for purposes of corroborating the availability findings and designing recommendations for appropriate rate ceiling.

An Overview

The composition of the rates (or revenues) at which credit services are provided is depicted in the accompanying diagram. After a brief description of the nature of costs involved available evidence concerning the composition of costs of various forms of credit grantors is reviewed.

Rate (revenue)

- Operating costs
  - Acquisition costs
  - Costs of processing and collecting
  - Bed debt losses
- Taxes
- Return on invested capital (cost of capital)

Operating Costs

Operating costs of a credit grantor arise from certain basic functions that must be performed. A cost analysis of a variety of credit grantors would reflect the same basic functions, although there would be somewhat different cost structures depending upon the amounts and maturities of credit extensions and the quality of customers served. This is an important principle. Because the processes of extending, servicing and collecting a personal loan or financing a refrigerator or used car are so similar, a rate ceiling on personal loans is probably adequate to cover equivalent amounts of such sales credit without affecting availability. Similarly, a rate ceiling derived from an analysis of the new auto market, where the average amount financed is around $3,000, will probably serve other forms of secured credit where amounts involved exceed $3,000.

To illustrate, a listing of activities relating to a retail revolving charge account is shown in Exhibit 7-13. Two points in the exhibit are worth noting. First, as brought out in hearings on the Consumer Credit Protection Act, a substantial portion of costs are not for "forebearance" but for handling costs:

> . . . I have been listening to this discussion today about interest on revolving charge accounts which I think more correctly could be called service charges or charge rates. Because obviously there is a lot of administrative work involved in charge accounts that are not necessarily in other types of credit transactions.[26]

Second, most costs of providing various services listed are unrelated to the amount of credit extended. Put another way, most of these costs are fixed; therefore, the smaller the dollar amount of credit involved, the higher the operating costs as a percentage of the amount of credit extended. In a competitive market fairly high APR's can be expected to be charged for extensions of small amounts of credit, even though the actual dollar finance charge might be quite small. These APR's could

EXHIBIT 7-13

Services Provided on Revolving Credit Account at Department Store

Services upon acquisition of account:

Interview with credit department.

Preparation of revolving credit contract including terms of monthly payment and notice of service charge.

Clerance of consumer's name with local credit bureau, other retail stores, place of employment, and possible personal references.

Decision of credit department to grant credit.

Makeup of charge plate for customer and issuance by mail.

Makeup of addressograph plate for customer, and makeup of blank monthly bill using addressograph plate.

Continuing services:

Daily authorization by credit department of all sales made in the store on revolving credit basis.

Daily processing of sales slips for each revolving credit account including filing by name in account files. These sales slips may be for purchases under $1, with the average transaction about $4 or $5.

Daily processing of merchandise returns including filing by account.

Daily processing of payments (normally paid monthly) received at window or by mail, including filing by account.

Continuous review of accounts for overbuying or lateness in payments.

Sending notices to delinquent customers.

Second and subsequent reviews of delinquent accounts and mailing of notices.

Monthly billing of each customer. This includes posting of all sales slips by date of purchase, deduction of merchandise returns and cash payments, calculation of service charge and entry on the bill, drawing the new unpaid balance, the photographing of all original sales slips, credits, and the customer's bill, and mailing the bill.

Other miscellaneous continuing factors include the handling of changes of address, the tracing of skips, the use of outside collectors, and the continued reexamination of accounts for degree of credit risk.

Source: Testimony of Duncan McC. Holthausen, Consumer Credit Labeling Bill, Hearings before a Subcommittee on Banking and Currency, U.S. Senate, 86th Cong., 2d Sess., (Washington, D.C.: U.S. Government Printing Office, 1960), pp. 348-59.

be expected to decline (at a decreasing rate) as the size of the credit extension grew larger.

A significant portion of total operating costs is associated with the assumption of risk. Each time a creditor provides credit, he is making a bet. Through credit judgment and credit scoring systems a creditor estimates the probability that a given applicant will be willing and able to repay the debt. If he guesses correctly, the revenue he receives for the credit service provides a return on invested capital. If he guesses wrong, he loses up to his entire investment in the account, as well as the costs involved in its processing. Thus, operating costs associated with the assumption of risks are reflected both in bad debt losses and in costs of collection efforts. Although bad debt losses are related to the amounts of credit extended, many costs of collection are fixed, regardless of the amount of credit involved. It costs just as much to send a dunning letter to collect a $25 payment as a $250 payment.

Return on Invested Capital. In any analysis of the effect of rate ceilings it is important to recognize that credit grantors face a highly competitive market in obtaining funds. Because an individual creditor who wishes to obtain borrowed or equity funds represents only a small fraction of the demand side of money and capital markets, he has virtually no control over the price he must pay for funds. Given his risk class, he must pay the market rate or do without funds. Once he has balanced his sources of funds in an optimal manner, the credit grantor has little control over the cost of his invested capital (more technically, his cost of capital). If he cannot generate adequate revenues, his firm will lose funds and decline in market value. If by shrewd management (or some degree of monopoly control of the market) he is able to earn a better return than other firms in his risk class, he will attract funds, and the firm may grow.

A credit grantor's cost of capital represents a required return—a return that must be earned if the value of the firm is to remain unchanged. Decreases in revenues that result from lower rates of increases in operating costs cannot be taken out of the return on invested funds without driving those funds into other lines of business.

EMPIRICAL EVIDENCE OF COSTS OF PROVIDING CREDIT

A number of studies of costs of providing consumer credit, some of them initiated by the Commission, are available, but most of them suffer from one inherent problem: they do not reflect the costs of providing credit in a free market. When rate ceilings are effective, a study of the costs of operation is, in a sense, self-fulfilling. If the rate ceiling is 10 percent, costs obviously have to be low enough to permit the lender to earn the required return on his invested funds. There may be few lenders in the market and only a minority of consumers who qualify for credit at that rate—but the resulting cost structure "justifies" a price ceiling of 10 percent. If costs were higher, the lender would soon be out of business.

Similarly, at higher rate ceilings, added competition tends to force those credit grantors serving marginal customers to assume more risk in order to acquire more customers. More risk means higher costs—and once again the measured costs may "justify" the higher price ceiling for that particular class of credit grantors.

Commercial Banks

For several years the Federal Reserve Banks have prepared and published a functional cost analysis in an effort to develop reasonably standardized cost accounting systems to allocate income and expenses to profit centers within cooperating commercial basis. Although no one would represent the results as the culmination of an exact science, the data concerning the instalment loan function within commercial banks are instructive.

The costs of commercial banks reflect the grade of credit risks acceptable under their established finance rates, which are typically below their rate ceilings. Often by choice and sometimes because of low rate ceilings, commercial banks generally serve a less risky and, therefore, less costly segment of the market than finance companies. There is not, however, a clear delineation between the markets. Commercial banks must perform the same basic services as other credit grantors, and the costs of many of these services are fixed, regardless of the amount of credit extended. The importance of these fixed costs is evident in Exhibit 7-14, which shows the APR's that commercial banks must earn to break even at various sizes and maturities of loan. The maturity of a loan is closely related to its size; that is, a consumer seldom borrows $500 for 36 months, $2,500 for 12 months. For this reason Exhibit 7-14 portrays those maturities most likely to be associated with the loan size shown on the horizontal axis.

The exhibit may be interpreted as follows. Unless a commercial bank receives at least 18 percent on a 12-month, $500 loan, its return is insufficient to cover its average operating costs, credit losses, and the required return on its invested capital.

Two features of the analysis produce substantial understatement of the APR required to break even. First, the cost of funds used in determining these data was only 3.67 percent before taxes, a figure considerably below any reasonable estimate of the overall cost of capital *before taxes* to commercial banks. Second, the instalment loans covered in the functional cost analysis include all direct loans, both unsecured personal loans and 36-month, secured new auto loans—as well as longer term loans on boats and mobile homes. Because the risks are probably greater on the small, unsecured loans than on the large loans, the APR that would be required on small loans is probably higher than shown in Exhibit 7-14.

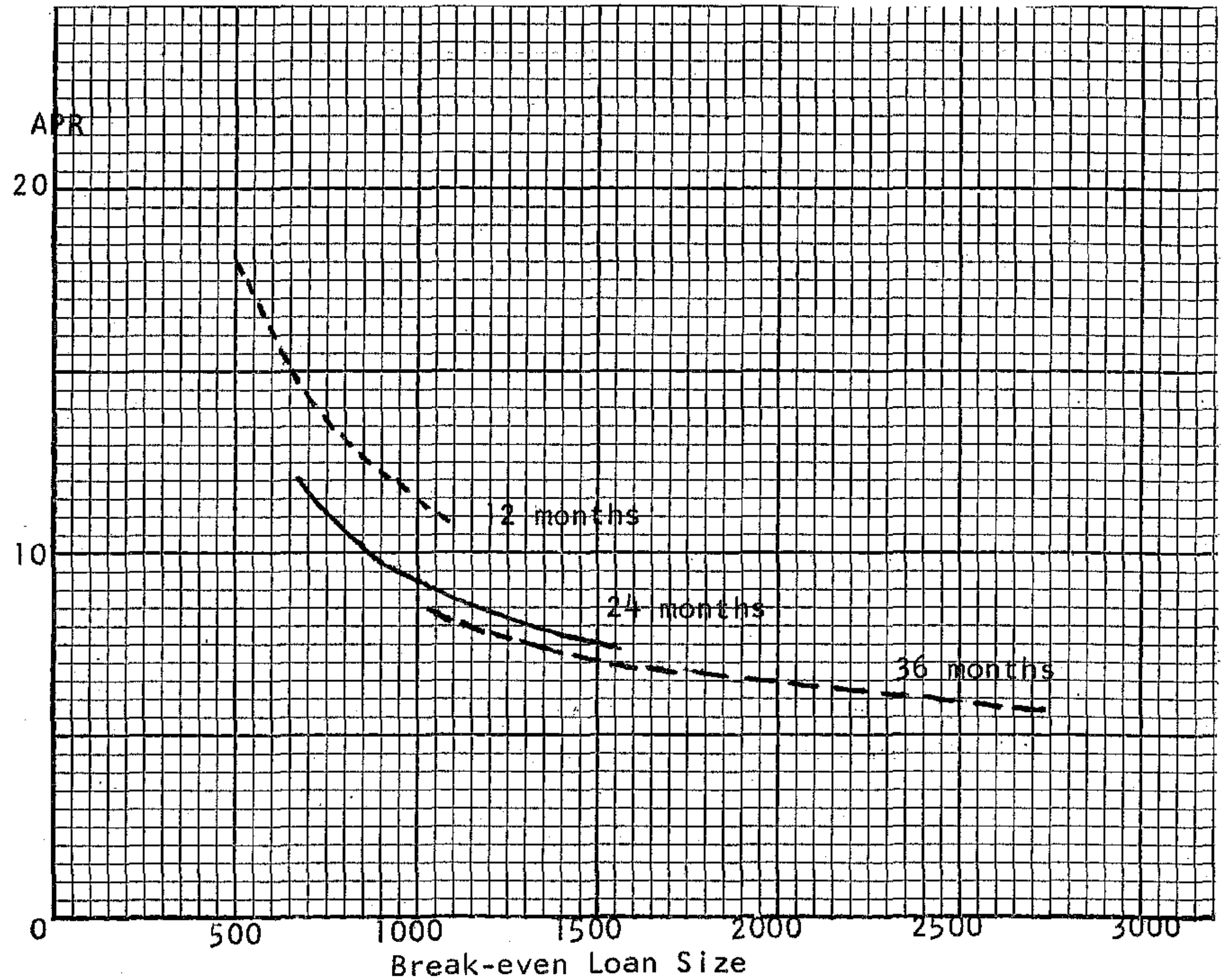
Even without these corrections, if the curves were extended in Exhibit 7-14 to loans below $500, the required APR would rise well above 20 percent. These data make clear why commercial banks are often reluctant to make small loans, especially if they entail much risk. In some states they are prevented from doing so by rate ceilings. In other states they choose not to do so because of the "image problem" of overtly charging the high rates necessary to cover costs of providing small amounts of credit. The exhibit also shows why lenders that do assume higher risks on small extensions of credit, such as consumer finance companies, find their costs of providing credit are often quite high as a percentage of the declining unpaid balance.

Consumer Finance Companies

The most recent data available to the Commission on the costs of consumer finance companies (also known as licensed lenders, personal finance companies, or small loan companies) are derived from a continuation of a major study by Paul F. Smith[27] and a special study for the Commission by George J. Benston. Data from the Smith study for 1964, shown in Exhibit 7-15, indicate that, on average, $12.73 per $100 of average outstanding credit was expended for "operating expenses" and $8.67 for "nonoperating expenses." Since the average loan size during the year these data were collected was $485 and the probable average maturity was 1 year, it is possible to estimate the APR required to cover total costs of lending various loan sizes for 1 year. When "provision for losses" is subtracted from operating expenses, the resulting $10.46 is the estimated cost, *per $100*, of putting a $485 loan on the books and servicing that loan for a year. Multiplying the number of hundreds upon which this estimate is based, 4.85 times the cost, $10.46, yields a fixed operating cost *per loan* of $50.73. This

EXHIBIT 7-14

Annual Percentage Rates Required to Break Even for Various Sizes of Loan, 665 Commercial Banks with Deposits up to $50 Million, 1970



Source: Federal Reserve System, *Functional Cost Analysis 1970 Average Banks* (1971), p. A16A. Cost of funds is assumed to be 3.67 percent before taxes.

Note to Exhibit 7-14

Consumer Instalment Loan Break-even Points — This exhibit indicates the minimum size of loan at selected rates and maturities that will generate income equal to average costs for such loans.

The consumer instalment loan break-even loan balances are calculated by equating income to costs by use of the following equation:

$$X = \frac{24(C_a + N\,C_p)}{2iN - (C_b + C_m)\ (N+1)}$$

C_a = Acquisition cost per loan

C_p = Processing cost per payment

C_b = Loan loss factory (7-year average)

C_m = Cost of money

i = Add-on finance rate — percent per year of unpaid balance

N = Number of payment periods

X = Break-even loan size

approximate cost would be incurred for each loan written, and serviced for 1 year, *regardless* of its size. The "provisions for losses" of $2.27 can be added to the nonoperating expenses of $8.67 per $100 to estimate a

EXHIBIT 7-15

Components of Finance Charges on Consumer Receivables, 1964, (Dollars per $100 of average outstanding credit)

Item	Amounts per $100 of average outstanding credit	Percentage distribution
Lender's income	$21.40	
Operating expenses	$12.73	100.0
Salaries	5.60	44.0
Occupancy costs	.98	7.7
Advertising	.71	5.6
Provisions for losses	2.27	17.8
Other	3.18	24.9
Nonoperating expenses (net operating income)	8.67	100.0
Interest	4.17	48.2
Income taxes	2.17	25.0
Cost of equity funds	2.33	26.8
Dividends $.79		
Retained Earnings 1.53		

Source: Paul F. Smith, "Recent Trends in the Financial Position of Nine Major Consumer Finance Companies," in John M. Chapman and Robert P. Shay, *The Consumer Finance Industry: Its Costs and Regulation* (New York: Columbia University Press, 1967), pp. 38, 40.

required percentage markup for variable expenses (expenses varying directly with the amount lent). This markup would be 10.94 percent per annum of the declining unpaid principal balance. In sum, an APR to cover full costs as of 1964 would allow $50.73 per loan plus 10.94 percent per annum variable cost markup. The Benston study for the years 1968, 1969, and 1970 confirms the validity of these approximations.

On the basis of these cost calculations, Exhibit 7-16 presents the calculated dollar finance charge and APR equivalents by size of loan up to $3,000. In addition to these calculations, alternative charges are presented assuming a 15 percent variable cost markup, which would allow for enlargement of the market through a higher degree of risk acceptance. By either markup, the APR falls rapidly over the smaller loan sizes because of the great relative weight of fixed operating costs, but for the larger loan sizes these costs are "spread" more evenly. The 28.43 APR for a 12-month, $500 loan here under the 11 percent markup is close to the 26 percent

EXHIBIT 7-16

Finance Charges and Corresponding APR's Necessary to Recover Total Estimated Costs—by Size of Loan

	$50 plus 11%		$50 plus 15%	
Amount Financed	Finance Charge	APR	Finance Charge	APR
$100	$56.06	91.36	$58.31	94.66
200	62.12	53.14	66.62	56.72
300	68.18	39.62	74.93	43.31
400	74.24	32.66	83.24	36.43
500	80.30	28.43	91.55	32.23
600	86.36	25.58	99.86	29.42
700	92.42	23.53	108.17	27.39
800	98.48	22.00	116.48	25.87
900	104.54	20.80	124.79	24.68
1,000	110.60	19.82	133.10	23.72
1,100	116.66	19.04	141.41	22.95
1,200	122.72	18.37	149.72	22.29
1,300	128.78	17.82	158.03	21.73
1,400	134.84	17.32	166.34	21.25
1,500	140.90	16.90	174.65	20.83
Average		29.76		33.57
1,600	146.96	16.54	182.96	20.48
1,700	153.02	16.21	191.27	20.15
1,800	159.08	15.93	199.58	19.88
1,900	165.14	15.67	207.89	19.62
2,000	171.20	15.45	216.20	19.39
2,100	177.26	15.23	224.51	19.18
2,200	183.32	15.04	232.82	18.98
2,300	189.38	14.86	241.13	18.82
2,400	195.44	14.70	249.44	18.66
2,500	201.50	14.55	257.75	18.52
2,600	207.56	14.41	266.06	18.38
2,700	213.62	14.29	274.37	18.25
2,800	219.68	14.18	282.68	18.14
2,900	225.74	14.07	290.99	18.02
3,000	231.80	13.98	299.30	17.93
Overall Average		22.38		26.26

rate estimated for the example of a 12-month, $500 commercial bank loan. The slightly higher rate can probably be accounted for by the higher level of risk acceptance typical of finance companies.

Recognizing that loans of $100 and $200 are more frequently made for 6- rather than 12-months, the required APR will be higher than in Exhibit 7-16, because costs of putting the loan on the books and servicing it must be recaptured over the shorter period of time.

When these costs are compared with existing finance company rate ceilings, it should be recalled that states graduate their rate ceilings very differently. For this reason the "average rate ceiling" used in the econometric analysis was a simple average computed over $100 intervals for loan sizes up to $1,500 (or the legal loan size limit, whichever was smaller, with a resulting average size of $570). Average APR's for the upper panels of Exhibit 7-16 are 29.76 percent and 33.57 percent for the 11 and 15 percent nonoperating expense assumptions, respectively. Any loan size limit which sought to make personal loans widely available would reach well above $1,500–probably to $3,000 or more. The lower panels of Exhibit 7-16 indicate that the required APR's would decline to 13.98 percent and 17.93 percent, while the average APR's would be 22.38 and 26.26 percent, respectively. Staff studies indicated that reductions in amounts of personal loans supplied by finance companies began with average rate ceilings of less than 28 to 30 percent. Any lower rate ceilings on the average size of loan of $570 would apparently curtail availability because revenues fail to cover required costs. When rate ceilings are below the levels indicated, staff studies show that finance companies can stay in business only by granting larger size loans, limiting their risk acceptance to more affluent consumers, and maintaining large volume offices.

Further insight into costs of providing consumer instalment credit is provided by Thomas A. Durkin's study for the Commission of the "small small" loan industry in Texas.[28] Companies in this specially licensed and regulated industry make loans of $100 or less. Results of the analysis of revenues and costs indicate that high rate ceilings permit firms to serve marginal, high risk customers. The study demonstrates that the fixed costs of providing consumer instalment credit become an increasing higher proportion of outstanding balance as the amount of credit extended declines.

With respect to the first point, comparison of Exhibits 7-15 and 7-17 shows that lender's income per $100 of average outstanding credit was about five times greater in the Texas small small loan industry than for nine national chains. However, the notably higher net bad debt expense and salaries suggest that the added income potential led these companies to extend credit to consumers in a significantly higher risk category. With respect to the second point, total operating costs absorbed about four-fifths of the gross income of the small small loan companies in Texas, but only three-fifths of the gross income of the nine major chains. In spite of their narrower margin, the Texas firms' total operating expenses amounted to almost 81 percent of average outstanding, compared with less than 13 percent for the major chains. These percentages represent the minimum APR's these firms would have to charge just to recover costs of operation, with no return on capital (interest, retailed earnings, and dividends) and no state or Federal income taxes. Thus from a *cost* standpoint the average charge to consumers of over 100 percent by the Texas small small loan companies (on average loans of about $65 in 1970) is as supportable as the average charge of 21.4 percent by the nine chains (on average loans of $485 in 1964). The variation is explained by significant differences in the risk class of consumers served and dollar amounts of credit extended. The difference is *not* explained by higher profits among small small loan companies. Quite the opposite. Net profits after taxes of the small small loan companies amounted to about 11.5 percent of equity funds in 1970, compared with 12.2 percent for the nine chain companies in 1964.[29]

Retailers

Among data available in the Commission's staff study of costs of retailers credit operations are those prepared by Touche, Ross, Bailey & Smart (now Touche Ross & Co.), from a detailed analysis of costs in 1968 of 10 large department stores and five small stores.[30] During that year the stores had combined sales of $1.2 billion and credit sales of over $690 million.

Problems of allocating costs and revenues to the credit function of retailers are as difficult as for commercial banks. Commission staff members reviewed the allocation procedures followed by Touche Ross, found them reasonable, but would make some adjustments in the concluding calculations.

First, the cost of capital derived in the study appears to mix pre-tax and after-tax costs.[31] Recalculation on the basis of data provided suggests that a reasonable minimum estimate of the after-tax cost of capital (the required return necessary to maintain the value of the firm) is about 8.7 percent.[32] For purposes of calculation, this is rounded downward to an after-tax cost of 8 percent.

The required return of 8 percent after taxes must be earned on the investment in the credit operation to cover the average cost of capital. Specifically, this is the

EXHIBIT 7-17

Components of Finance Charges on Consumer Receivables of Small Small Loan Industry in Texas, 1970

(Dollars per $100 of average outstanding credit)

Item	Amounts per $100 of average outstanding credit	Percentage distribution
Lender's income	$101.08	
Operating expenses	80.92	100.0
Salaries	40.78	50.4
Occupancy & other	30.37	37.5
Net bad debts	9.77	12.1
Nonoperating expenses (net operating income)	20.16	100.0
Interest	2.95	14.6
Income taxes	6.21	30.8
Cost of equity funds	11.00	54.6

Average loans outstanding are average monthly outstandings.

Source: Thomas A. Durkin, *A High-Rate Market for Consumer Loans: The Small Small Loan Industry in Texas* (Washington D.C.: National Commission on Consumer Finance, 1972), Table IV.

investment in accounts receivable and in credit equipment, both computer and noncomputer. The data cited seem to depict only the cost of capital on accounts receivable. Exhibit 7-18 sets out what the Commission belies to be a more accurate computation of the excess of credit expenses over credit service charge income in the Touche Ross analysis.

Credit Unions

Credit union cost data are distorted because they pay no state or Federal income taxes and often benefit from free space and equipment provided by the employer of the members and from donated services of personnel. This makes credit unions almost irrelevant for the purpose at hand, but they should not be ignored.

During 1970, "almost three-fourths of all loans granted by Federal credit unions were at the 1 percent maximum [12 percent per annum]."[33] Of the income received, about 38 percent was absorbed by operating costs (itemized in Exhibit 7-19), with the balance representing the return on invested capital. It is evident from the exhibit that salaries were the largest component of operating costs, despite donated services.

Commission interest in the availability of credit to low income consumers led to funding a special study of the performance of limited income and OEO-funded credit unions.[34] These are usually Federal credit unions. Members include those whose annual income falls within the poverty classification established by the Federal Office of Economic Opportunity, residents of public housing projects, or individuals who qualify as recipients in a community action program. Income and expenses of 629 of these credit unions in 1970 are tabulated in Exhibit 7-19. Operating costs of limited income credit unions amounted to almost 50 percent of total income; the remainder was return on invested capital.

But these data do not adequately disclose the costs of providing small amounts of cash credit to low income consumers. A substantial portion of the "other income" of limited income credit unions came from various subsidies. In a special study of OEO-funded credit unions, (a subset of limited income credit unions) Thomas A. Cargill estimated the "rate of finance charge that the OEO-funded credit unions [would] have to impose on their members in the absence of any subsidy to cover total expenses."[35] Adding back the estimated subsidy of $5.86 per $100 of outstanding credit brought the total "real" finance charge to about $14.94 per $100 of outstanding balance, approximately 15 percent per annum and well above the rate currently permitted Federal credit unions. Even with the subsidy, less than

EXHIBIT 7-18

Revolving Credit Service Charge Revenues and Costs of Fifteen Department Stores, 1968

(in thousands of dollars)

Credit service charge revenue	$26,328.9
Pre-tax credit costs[a]	23,016.1
Taxable income	3,312.8
Taxes (estimated at 50%)	1,656.4
Income after taxes	$ 1,656.4

After-tax cost of capital[b]	X	Investment in accounts receivable and in credit equipment	=	Required return
8%	X	($182,687.5 + ?) = $14,615.0 + ?	=	Required return

Minimum deficiency of actual return to required return =
$14,615.0 - $1,656.4 = $12,958.6

[a] Exclusive of the costs of capital.

[b] For estimate of after-tax cost of capital, see footnote 32.

half of these credit unions paid any dividends during 1969, compared with 87 percent of all Federal credit unions.

RATE CEILING POLICY MEASURES RECOMMENDED

Rate ceilings in many states restrict the supply of credit and eliminate creditworthy borrowers from consumer credit markets. Some seek out less desirable alternatives, such as low quality credit sellers and illegal lenders. Furthermore, many borrowers who are not rejected pay rates of charge higher than they would be charged in workably competitive markets.

This situation could be changed by eliminating rate ceilings and relying on competition to ensure that borrowers pay reasonable rates for the use of credit. But the statistical evidence considered here indicates that competition cannot be relied upon at this point in time to establish rates at reasonably competitive levels in many states. Raising rate ceilings in some areas where markets are highly concentrated would merely allow suppliers to raise prices, accept somewhat higher risks, but remain secure within the legal or other barriers which assure them that their market power and monopoly profits will not be diluted.

Clearly, then, rate ceilings cannot be eliminated until workably competitive markets exist. But, reasonably competitive markets cannot be expected to exist where low rate ceilings have driven many competitors from markets. In some instances, higher rate ceilings must be accompanied by policies to ensure that new competitors enter the market.

The Commission recommends that each state evaluate the competitiveness of its markets before considering raising or lowering rate ceilings from present levels. It has been noted that low rate ceilings appear to inhibit the availability of credit most heavily in the personal loan market and, most significantly, in the higher risk, higher rate portion of that market served by consumer finance companies. Since states with low rate ceilings tend to be those with highly concentrated markets, the Commission urges that any policy regarding eliminating or raising rate ceilings in licensed lending be accompanied by implementing policies previously recommended to foster vigorous competition. The same considerations dictate caution regarding attempts to lower the rate ceilings in licensed lending. While lower rate ceilings in certain cases may bring about lower average rates of charge, the resulting dominance of the market by giant firms and restrictions on availability can be expected to cause rates to rise to levels significantly higher than those set by competition unless the other policies recommended by the Commission to achieve workably competitive markets are adopted.

For these reasons, states where current rate ceilings constrain the development of workably competitive

EXHIBIT 7-19

Income and Expenses of Federal Credit Unions and Limited Income Credit Unions, 1970

(Dollar amounts in thousands)

	Federal credit unions		Limited income credit unions	
	Amount	Percentage distribution	Amount	Percentage distribution
Total income	$773,000	100.0	$4,877	100.0
Interest on loans		88.6		74.0
Income from investments		9.8		10.6
Other income		1.6		15.4
Total expenses	$292,000	100.0	$2,418	100.0
Total salaries		39.4		38.3
Borrowers' insurance		13.4		11.3
Life savings insurance		8.9		9.0
League dues		2.5		2.9
Surety bond premiums		0.8		1.0
Examination fees		2.5		3.8
Interest paid		4.6		1.5
Cost of space		2.1		4.5
Educational expense		2.0		2.0
Depreciation		2.0		1.3
Other insurance		1.2		1.3
Communications		1.9		1.5
Accounting services		2.6		1.6
Conventions & conf.		1.1		0.8
Supervisory committee exp.		0.6		0.3
Annual meeting expense		1.1		1.0
All other expense		13.4		17.9
Net income	$481,00		$2,459	

Source: Data for all Federal credit unions are from the *1970 Annual Report of the National Credit Unions Administration;* for limited income credit unions, from Thomas F. Cargill, *Performance of Limited-Income Credit Unions:* 1969-1970 (Washington, D.C.; National Commission on Consumer Finance, 1972), Table 5. These latter data are included in the totals for Federal credit unions.

markets should consider revising their rate ceilings if they seek to increase credit availability at reasonable rates of charge. The Commission staff, through estimated cost, statistical, and other studies, has determined that a rate structure with an average APR of 22-26 percent for loans up to and including $3,000 would provide an opportunity for developing workable competition in consumer credit markets. A Commission staff study provides guidelines for developing a graduated rate ceiling structure to assure the offer of loans of all sizes. States should adopt a similar approach to changes in rate ceilings in other consumer credit markets.

The Commission recommends that policies designed to promote competition should be given the first priority, with adjustment of rate ceilings used as a complement to expand the availability of credit. As the development of workably competitive markets decreases the need for rate ceilings to combat market power in concentrated markets, such ceilings may be raised or removed.

The Commission notes that those states which are determined to provide an opportunity for workable competition in consumer credit markets may adopt a graduated rate structure along the lines suggested by the Commission staff studies.[36] Those states which for other reasons provide rate ceilings which are lower than those discussed herein should carefully monitor the adequacy of the availability of consumer credit within the state. Rate ceilings below those indicated in Commission studies may tend to inhibit the functioning of a competitive market and restrict the availability of consumer credit. Such states should also monitor the effect on high risk borrowers since lower rate ceilings tend to eliminate such borrowers from the legal consumer credit markets.

Chapter 8

SPECIAL PROBLEMS OF UNAVAILABILITY

DISCRIMINATION

Because credit is so important to American consumers, the Commission believes that it should be available to every creditworthy applicant on a nondiscriminatory basis. The Commission views credit not as a universal right, but as a privilege for the deserving. It believes that every consumer should have an equal opportunity for access to the credit market and that credit should never be denied solely because of characteristics such as race, creed, color, occupation, or sex.

Because any one of these and other factors could be used as a basis for discrimination, the Commission first had to define what it meant by discrimination.

Definition of discrimination

Webster's Third New International Dictionary provides two pertinent definitions of "discriminate:"

1. to make a distinction: distinguish accurately . . . to use discernment of good judgment. . .
2. to make a difference in treatment or favor on a class or categorical basis in disregard of individual merit.

The Commission found both definitions relevant to its deliberations on discrimination.

It is obviously in the self-interest of credit grantors to distinguish accurately between good and bad credit risks—between those who will repay and those who will not—*prior* to granting credit. If credit grantors could "distinguish accurately" on a case-by-case basis, they would be able to avoid wholesale discrimination on a class or categorical basis. They would also be able to eliminate all bad debt losses stemming from inability to judge their applicants' willingness and ability to repay in the context of future events.

An analogy to insurance points up the problem. For instance, the following figures are quoted for automobile insurance rates for a one-car family in a midwestern city:

	Age of son or daughter			
	16	17	18	19
Parents, one son	$196	$187	$179	$170
Parents, one daughter	110	106	101	96
Difference	$ 86	$ 81	$ 78	$ 74

Other factors, of course, such as the type of car and record, if any, of driver education, would affect the actual insurance premium in individual cases. Nonetheless, if other factors are held constant, *as a class* families with one daughter pay much lower premiums than those with one son. This is certainly discrimination in the second sense of the definition.

Why do insurance companies discriminate in this fashion? Actuarial tables show that, generally, young men have more accidents than young women, so it is to the insurance companies' self-interest to avoid writing insurance on accident prone drivers. If they could discriminate on a case-by-case basis in advance, they would not write insurance on drivers about to have accidents. But they lack perfect foresight. Because they are unable to be certain which applicants will have accidents, they assign applicants to categories of risk. All within a given category pay a premium rate designed for the expected probability of accident for that group.

There are two possible alternatives to the present "discriminatory" system. Insurance companies could charge the same premium rate to all families, regardless of whether the youthful driver were male or female. This method would eliminate the class discrimination but would fail to "use discernment or good judgment." Premium rate differentials represent actual experience with young male and young female drivers. Although many young males are careful drivers who deserve lower premiums, relatively more young female drivers are better insurance risks. The two-rate system is unfair to

496-072 O - 73 - 12

some proportion of young men, but a one-rate system would be unfair to a much higher proportion of young women. Eliminating the present two-rate system would introduce more discrimination than exists now.

Alternatively, auto insurance companies might be urged (or required) to refine their categories so that subgroups of young male drivers could be identified according to their accident potential. There are at least two problems with this approach. First, as groups become smaller and smaller, the statistical validity of experience lessens to the point at which, with only one person to a classification, there is no valid statistical experience to draw upon. Second, the cost of developing a classification system, then obtaining requisite information from each applicant and processing and evaluating the information, increases geometrically with each additional item of information sought. Costs of further refinements to the system would soon raise insurance premiums, and thereby impose a new form of discrimination.

Credit grantors face the same type of problem. To illustrate, the credit scoring sheet for one major finance company provides 15 points if the applicant has been employed on the same job for 8 to 14 years but only three points if employed on the same job for 1 to 5 years. This discrimination by category has been shown statistically to aid in differentiating good accounts from less desirable accounts. (Fourteen other factors enter into the final credit decision.) No one proposes the finance company be required to end this form of discrimination or, to reach for the absurd, to accept on a random basis every third new applicant without *any* discrimination "on a class or categorical basis." Such a system would force customers who repay their debts to subsidize those who do not. To be able to discern risk among credit applicants more accurately requires the use of more than 15 variables. As the system becomes more finely honed, fewer consumers are discriminated against because they are classified more precisely into smaller and smaller risk categories. But the cost of the system increases rapidly as new variables are added, and benefits to individual consumers are outweighed by the added burden of costs placed on all consumers.

One advantage of a competitive economic system and reason the Commission presses for measures to assure competition in the consumer credit market is that discrimination based on class distinctions is minimized in a competitive market. If some credit grantor uses an archaic rule of thumb to deny credit to certain classes of consumers, it will be in the self-interest of competitors to identify good risks among such consumers and offer them credit. It is in the self-interest of each credit grantor to develop ability to discriminate between potentially good and bad accounts by better training of personnel and by designing effective credit scoring systems. Credit grantors, like insurance companies, deal with classes of applicants and turn away some good accounts along with bad accounts in the process. But the goad of competition should minimize rejection of creditworthy applicants. Sophisticated scoring systems have been developed to do just that.

Some form of discrimination is inevitable under either definition of the word. But discrimination based on class or category can be minimized when competition forces credit grantors to separate as accurately as possible consumers who are likely to pay from those who are likely to default.

Sex discrimination. At its hearings in May 1972, the Commission was presented with numerous documented accounts of difficulties women face in obtaining consumer as well as mortgage credit. Because the Commission study was limited to consumer credit, it transmitted information concerning discrimination against women in granting mortgage credit to various Federal agencies with jurisdiction over mortgage lending practices: the Federal Home Loan Bank Board, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, Federal Housing Administration, Veterans Administration, and Farmers Home Administration.

With respect to sex discrimination in the field of consumer credit, testimony presented at the hearings can be summarized as follows:

1. Single women have more trouble obtaining credit than single men. (This appeared to be more characteristic of mortgage credit than of consumer credit.)
2. Creditors generally require a woman upon marriage to reapply for credit, usually in her husband's name. Similar reapplication is not asked of men when they marry:

> Shortly after my marriage I wrote all the stores where I had charge accounts and requested new credit cards with my new name and address. That's all that had changed—my name and address. Otherwise, I maintained the same status—the same job, the same salary, and, presumably, the same credit rating. The response of the stores was swift. One store closed my account immediately. All of them sent me application forms to open a new account—forms that asked for my husband's name, my husband's bank, my husband's employer. There was no longer any interest in me, my job, my bank, or my ability to pay my own bills. [1]

3. Creditors are often unwilling to extend credit to a married woman in her own name:

> . . . credit cards and accounts are virtually always issued in the name of the husband and not the wife, no matter if the woman is the applicant and is the more creditworthy of the two. Women who inquire, upon finding their credit

issued to their nonapplicant spouse, are advised flatly, as a licensee of National BankAmericard advises, "BankAmericards are issued in the name of the husband," or "our policy allows card in the husband's name only."[2]

4. Creditors are often unwilling to count the wife's income when a married couple applies for credit:

I am married but have a job and need transportation. I tried a credit union and two small loan companies to finance a car. All said it would be my husband's credit, not mine, that they would go on. My husband has been ill for several years and naturally has not worked steady. On the other hand, I work seven days a week at two jobs (one full time, one part time). And I think it very unfair they will not take that as a fact. It is getting rather monotonous asking for rides home.[3]

5. Women who are divorced or widowed have trouble re-establishing credit. Women who are separated have a particularly difficult time, since the accounts may still be in the husband's name.

The anecdotal evidence was supplemented by a survey of 23 commercial banks conducted by the St. Paul Department of Human Rights. A man and a woman with virtually identical qualifications applied for a $600 loan to finance a used car without the signature of the other spouse. Each applicant was the wage earner, and the spouse was in school. Eleven of the banks visited by the woman "either strictly required the husband's signature or stated it was their preference although they would accept an application and possibly make an exception to the general policy."[4] When the same banks, plus two additional banks that would make no commitment to the female applicant, were visited by the male interviewer, six said that they would prefer both signatures but would make an exception for him; one insisted on both signatures; and six "told the male interviewer that he, as a married man, could obtain the loan without his wife's signature."[5]

Many practices to which witnesses objected have been inherited from past decades, if not centuries. They fail to reflect the times. The extensive publicity that accompanied the Commission's hearings has caused many credit grantors to reexamine their policies with respect to the existence of sex discrimination. In a competitive market, creditors responsive to these complaints will capture business from their more archaic competitors.

However, certain changes need to be made in state laws that hinder admission of creditworthy women to the credit society. First, alimony, support, and dower or curtesy laws of some states may cause creditors to believe they are assuming undue risk by granting credit solely on the wife's signature. *The Commission recommends that states undertake an immediate and thorough review of the degree to which their laws inhibit the granting of credit to creditworthy women and amend them, where necessary, to assure that credit is not restricted because of a person's sex.* Second, as creditors point out, most state statutes fixing a graduated rate ceiling on consumer credit transactions usually prohibit the maintenance by creditors of separate accounts for husband and wife. The purpose of this limitation is to minimize the aggregate finance charge. It seems reasonable to permit a husband and wife to have separate accounts if they wish and if they are provided with a full disclosure of the possible added costs. The National Conference of Commissioners on Uniform State Laws should examine the legal aspects of these restraints.

Racial discrimination

Historically, minority groups have faced discrimination in the nation's economic and social structures.

In the early part of this century, black scholars examined particular social practices that discriminated against the black population. Later, Swedish sociologist Gunnar Myrdal published a lengthy study of the effects of prejudice against minorities in the United States. The 1954 Supreme Court decision in *Brown, et al* v. *Board of Education of Topeka, et al.*[6] and civil rights demonstrations in the mid-fifties, starting with the Montgomery, Alabama, bus boycott in 1955, led behavioral scientists to deeper investigations into racial or ethnic discrimination and its effects. Many academic, political, and popular writers then began looking into economic practices which discriminated against U.S. minority groups—particularly blacks and Puerto Ricans—and published their findings and opinions.[7]

In the vanguard of such literature was Columbia University sociologist David Caplovitz's *The Poor Pay More*. The following year Senator Warren G. Magnuson and Jean Carper authored *The Dark Side of the Marketplace* which devoted a chapter to the economics of the ghetto marketplace.

Frederick D. Sturdivant, alone and in collaboration with Walter T. Wilhelm, narrowed exploration of a nationwide problem to the Los Angeles area. In "Poverty, Minorities and Consumer Exploitation,"[8] Sturdivant and Wilhelm found that credit charges were frequently used by merchants in ghetto areas of Los Angeles as a vehicle to practice economic, racial and ethnic discrimination against instalment buyers. Their study indicated that economic discrimination was a feature of any type of ghetto marketplace, and that within those marketplaces price or credit discrimination might be practiced against other minorities who went outside their own area to shop in another ghetto business

district. Sturdivant and Wilhelm examined two ghetto business areas—the south central section of Los Angeles which includes Watts, shopped mostly by blacks, and East Los Angeles, shopped mostly by Mexican-Americans. They used the Culver City marketplace as a white Anglo-Saxon middle class control area.

Three couples—one Negro, one Mexican-American, and one Anglo white—were selected to do comparative shopping for a black and white TV set at designated stores which carried certain models in the three areas. The credit profiles of all three couples were similar as to family status, age of head of household, employment, income, savings, assets, and indebtedness.

Results of the shopping expedition are shown in the following table.[9]

Retail[2] and Credit[3] Prices Portable TV Sets by Area, Store, Brand, and Race

	ZENITH–X1910			OLYMPIC–9P46			RCA–AH0668			ZENITH–X2014		
Area & Store	Negro	M-A	Anglo	Negro	M-A	Anglo	Negro	M-A	Anglo	Negro	M-A	Anglo
East L.A.												
Store 1				$200 ($265)	$240 ($281)	$230 ($284)						
Store 2[1]												
Store 3										$210 ($245)	$210 ($250)	$204 ($258)
Watts												
Store 1	$170 ($194)	$170 ($194)	$170 ($194)									
Store 2							$148 ($178)	$148 ($169)	$148 ($174)			
Store 3				$270 ($412)	$270 ($507)	$270 ($418)						
Culver City												
Store 1							$119 ($172)	$119 ($169)	$109 ($122)			
Store 2										$140 ($183)	$140 ($183)	$140 ($203)
Store 3	$130 ($145)	$130 ($152)	$130 ($140)									

[1] The model preselected for this store was sold before the experiment was completed.
[2] Retail prices refer to the price asked for the product before adding on interest charges.
[3] Credit prices, *shown in parentheses,* are the total of retail prices plus interest.

Sturdivant and Wilhelm concluded from their study that their "findings demonstrate that instalment purchases, which especially characterize the purchasing behavior of the disadvantaged produce major variations in the price paid by the poor."[10] While acknowledging that no perfect pattern of discrimination based on minority group status was evident, they said it was "common for the couples to be charged higher credit costs when shopping outside of their own areas."[11] They went on to say that "the findings indicate that merchants find credit charges an excellent vehicle for exercising economic and racial or ethnic discrimination, but . . . that however substantial and illegal many of these charges may be, they are not as significant as price variations between disadvantaged and prosperous areas."[12]

The possibility of racial discrimination in granting credit was examined for the Commission by Professor Gary G. Chandler of Georgia State University.[13] His analysis related levels of family debt (all forms of debt owed) to economic and demographic characteristics of families interviewed for the Office of Economic Opportunity in February 1967. Chandler's study was based on data from 4,306 families living in poverty areas and 3,893 families living in nonpoverty areas within central cities.

From his statistical analysis, Chandler estimated the association of race (white versus nonwhite) with levels of debt owed by families in central cities and in poverty and nonpoverty areas within central cities. In the *poverty* areas he found no evidence of variations in debt levels attributable to race. Within central cities as a whole, there was some evidence that nonwhite families had somewhat higher levels of debt than their white counterparts, other things being equal. But the finding must be regarded as questionable because it was indicated by only one of three statistical tests.

Chandler's most striking conclusion came from analysis of white and nonwhite families living in nonpoverty areas. Here all three statistical tests confirmed that race did make a difference. Other things being equal, nonwhite families had significantly higher levels of debt than white families—somewhere in the range of $730 to $1,020 per family on average.[14] This does not prove that discrimination against nonwhites is absent in the granting of credit but neither does it support its existence.

The causes of higher levels of debt among nonwhite families living in central city nonpoverty areas may represent a greater willingness to go into debt or a greater need for debt-financed assets. Or it may indicate that nonwhites go into debt to move from poverty areas, or at least to finance costs of transition. Part of the explanation may lie in the unexplained variance (ranging from 45 to 60 percent in the three regression models used). Whatever the reason, overall results fail to support charges of discrimination against nonwhites in central cities or within poverty and nonpoverty areas in central cities.

Residential discrimination. Chandler also examined the impact of living in a poverty area on the level of debt. In analyzing the influence of a family's residence on debt levels, he concluded that those living in nonpoverty areas had higher average levels of debt than those in poverty areas. This was true even after considering the effect on debt levels of other variables, such as income, liquid assets, and age. The difference in average debt level was in the range of $540 to $1,090, depending upon the estimating equation used. These results were confirmed by each of three statistical tests.

The variation cannot be explained by the higher debt levels of nonwhites in the nonpoverty areas, since they constituted less than one-fifth of the population. In part, the variation may stem from differences in buying habits, such as relatively greater demands for automobiles and other durable goods. A portion of the difference also arises on the supply side because of inner city poverty areas where creditors are unwilling and unable to send collectors. The high probability that a debt default by a poverty area resident will lead to total loss of the uncollected balance undoubtedly restricts availability of legal credit to residents of these areas. The situation is to be deplored but can hardly be viewed as unwarranted discrimination if the creditor is unable to collect just debts.

Conclusions. If a credit applicant is dishonest in providing credit information, that, in itself, is justifiable grounds for denial of credit. For example, if an applicant states he has been on a job for 10 years and verification reveals that he has been working for only 3 months, a creditor is warranted in refusing to extend credit. Except for cases of clear dishonesty, a creditor is not justified in denying credit *solely* on the basis of one characteristic, such as sex, race, or residence. Because a creditor's own self-interest works against using only one criterion in making credit decisions, this discriminatory behavior does not appear to be widespread. A review of several credit scoring systems currently in use demonstrates that creditors usually weigh a combination of a considerable number of factors that can be shown actuarially to identify the creditworthiness of applicants.

At its hearings, the Commission was urged to support legislation which would make it illegal to discriminate solely on the basis of sex or marital status in the granting of credit. These are only two of many possible bases for discrimination which also include age, time on job, years in residence, and size of family. Legislation cannot spell out how credit grantors should evaluate all of the factors reflecting a consumer's credit standing, because the relative importance of those factors varies widely among credit grantors and localities. But a credit grantor should be able to demonstrate a valid basis for his weighting of credit factors to show that his credit evaluation is not based purely on intuition, some ancient rule of thumb, or law long since repealed. The Commission finds that statistically-based discrimination is as acceptable in extending consumer credit as it is in underwriting insurance. This form of discrimination derives estimates from past experience about probabilities that a member of a class is likely to die, have an accident, or not pay obligations. Assessing these possibilities, it is appropriate that 30-year old men pay lower life insurance premiums than men aged 60; that young women drivers pay lower auto insurance premiums than young men drivers; and

that individuals with steady employment, good payment records, and savings accounts pay lower finance charges (or have more credit available) than consumers with a lower probability of repaying their debts.

The Commission believes that legislation requiring use of statistical credit scoring systems would be biased against small credit grantors who could not afford such expensive analyses. The same effect can be achieved by less sophisticated competent credit evaluation. If Commission recommendations designed to make markets more competitive are adopted, creditors will be forced by self-interest to evaluate credit applicants more precisely. As noted earlier, Commission hearings have led bank credit card franchisees, retailers, and others to reconsider policies that involve sex discrimination. Improvements must be made in this area, and the proposed Bureau of Consumer Credit (BCC) should undertake continuing studies similar to the St. Paul Department of Human Rights survey. If significant improvement -- both in consumer credit and mortgage credit--is not evident, the BCC should draft relevant legislation for consideration by Congress.

AVAILABILITY OF CREDIT TO THE POOR

The Commission is particularly concerned with the cost and availability of credit to low income consumers. Again, it is necessary to define the issue. Is the concern that consumers with low and variable incomes pay "too much" for their credit? Many characteristics of families with low incomes are actuarially associated with higher credit risks: large families, high level of unemployment, high frequency of part-time employment, and a high proportion of unskilled workers.[15] To the extent that low incomes are associated with high risk, it can be expected that costs of credit would be higher for such consumers than for more affluent consumers just as funds cost considerably more for risky business ventures than for stable corporations. This could be changed by government intervention but would require a major restructuring of the economic system.

It is also a fact that low income families acquire instalment debt less frequently than higher income families as shown in the following data from early 1971:[16]

	Percentage having instalment debt
All families	48
Annual family income	
Less than $3,000	29
$3,000 - 4,999	39
$5,000 - 7,499	51
$7,500 - 9,999	53
$10,000 - 14,999	60
$15,000 or more	46

Is the issue that families with incomes below $5,000 acquire instalment debt with less frequency than families with incomes of $7,500 to $15,000? As a practical matter, it is doubtful that families with low and often irregular incomes could fulfill credit obligations as readily as those with higher incomes. Indeed, concern about inadequate availability of credit to the poor is in direct conflict with an issue raised just as frequently that the poor receive "too much" credit and become overburdened with debt. The only way these two concerns can be reconciled is to assume that among families with incomes of less than $3,000, the 29 percent who have debt are overburdened and the 71 percent without instalment debt have been unfairly deprived. This is not a persuasive position.

It should not be surprising that, compared with more affluent consumers, those with low and uncertain incomes pay higher rates of finance charge but find credit less available. This is understandable.

What *are* the issues of credit and the poor? First, legal credit should be made available to the poor at competitive rates of charge. Earlier the Commission concluded that combined retail prices and finance charges would be reduced to low income consumers if rate ceilings on cash loans were adequate to permit cash lenders to compete effectively with credit retailers in poverty areas. Second, low income consumers who need credit and who could and would repay their obligations should not be denied credit solely on the basis of their low incomes. This objective is analagous to the goal of eliminating other forms of discrimination not warranted by statistical evidence.

Present programs for providing credit to the poor

Long before low income consumers became a matter of intense public concern, private credit grantors extended credit to them. These credit grantors included retailers, credit unions, and finance companies. In recent years the Federal Government initiated experimental programs for providing credit to the poor, principally through low income credit unions.

Private industry. Evidence available to the Commission suggests that many low income families are already served by legitimate credit grantors. Somewhat surprisingly, a significant proportion of low income consumers have credit cards. A survey in metropolitan Atlanta showed that over 37 percent of households with gross incomes of less than $5,000 had an average of 1.78 credit cards: 12 percent, gasoline; 14.6 percent, bank; and 32.2 percent, retail cards.[17] Since so-called "schlock" credit merchants seldom issue credit cards, it can be assumed that low income households having retail credit cards had access to the same quality of goods and credit services as more affluent consumers.

A large retailer gave the Commission detailed surveys made for it by an independent research firm. One investigation was made of low income zip code areas in five cities designated by the Office of Economic Opportunity as poverty areas. Just over 23 percent of households in these areas had credit accounts with the retailer, a market penetration only slightly less than the retailer's overall position in the United States. By personal surveys it was determined that 6.8 percent of the credit accounts in zip code areas in St. Louis and 8.6 percent in Washington, D.C. were welfare recipients. In the six zip-code poverty areas in Washington, the retailer had accounts with 28.3 percent of the households, ranging from 5.4 percent with incomes below $3,000 to over half with incomes of $15,000 or more. Accounts in poverty zip code areas had twice the level of delinquency as accounts in other zip code areas. The retailer administers all collection from the same control location so that procedures and other criteria are identical.

Another way of providing cash credit to the poor is in operation in Texas where "small small" loan statutes permit loans of $100 or less to be made under a graduated rate schedule which ranges up to 240 percent for very small amounts. A study prepared for the Commission by Thomas A. Durkin, a Columbia University doctoral student, found that, while only 2.4 percent of borrowers were aware of the APR, 66.3 percent were aware of the finance charge in dollars. Two-thirds were aware of less costly sources of credit, but used the "small small" loan companies, and 84.7 percent said that the loan was "worth it."[18] This group of low income borrowers had a good idea of what they were doing and why they were doing it. It is somewhat presumptuous for affluent consumers to assert that these low income consumers should not have borrowed at these rates to pay old bills and medical and automobile expenses. Because the alternative to these regulated lenders could be the brutality of loan sharks, some state legislatures decided to authorize "small small" loans under state supervision, even at very high rates of finance charge. Over the long run this is not a desirable form of credit but it may be a satisfactory interim arrangement until a better solution to problems of credit and the poor is achieved.

Besides normal extensions of credit to low income consumers, some credit grantors have participated in experimental programs to provide credit to certain low income consumers. These consumers are often screened initially by an outside group such as the National Welfare Rights Organization. Results of a special study of these programs indicate a relatively high level of delinquencies and losses.[19] On 667 accounts accepted through April 1971, one retailer reported bad debt losses of 12 percent compared with normal losses of 0.4 percent. Another retailer operating in several states with 768 such accounts recorded a delinquency rate of 23.6 percent and bad debt losses of 7.3 percent, compared with a normal loss of 2 percent of sales. A third retailer dealing with prescreened customers recorded bad debts of 18.1 percent of sales compared with a normal loss of 2 percent. One bank's experience with an experimental program in New York cited bad debt losses of 14 percent compared with a normal loss ratio below 1 percent of extensions.

Causes of these credit losses could not be determined, but it is clear that losses of this magnitude cannot be supported by a private credit grantor at rates customarily charged unless the creditor elects to have other customers subsidize the losses. Without such forced subsidies, retailers could only extend credit regularly to this high risk segment of the market by substantially raising finance charges or cash prices. One reason that low income retailers in the District of Columbia raise their time prices so much higher than general market retailers is that their bad debt losses as a percentage of sales are about 23 times higher.[20]

Bleak as this picture may appear, there is a positive side. In spite of the fact that the 11 retailers surveyed had bad debt losses, typically in the range of 10 to 20 percent of sales, 80 to 90 percent of credit sales *were* eventually collected. Although these "good" accounts entailed above-average rates of delinquency and extra collection costs, some could have been profitable to the credit grantors while providing relatively low cost credit to consumers. Present screening techniques are not adequate to identify these accounts, but there are possible avenues for improvement.

Government. In recent years joint efforts of the National Credit Union Administration (formerly the Bureau of Federal Credit Unions), Credit Union National Association, Inc., and OEO resulted in the formation of a number of credit unions in low income areas. At the end of 1970 there were 629 federally chartered limited-income credit unions, the majority of which were chartered after 1960. About half are OEO-related credit unions that received about $2.1 million in direct assistance in 1969 and 1970 out of a total of $3.2 million provided annually by OEO to the credit union program. Thomas F. Cargill noted in a study for the Commission: "These figures are only approximate because it was not possible to obtain an exact listing of OEO-related credit unions or a tabulation of how the annual funding of $3.2 million was allocated directly or indirectly to specific OEO-related credit unions."[21]

Cargill attempted to determine the delinquency and loss experience of the limited-income credit unions. To avoid bias, he compared their experience with other small credit unions. At the end of 1970 the number of

delinquent loans of low income credit unions was 20.1 percent of total loans outstanding, compared with 9.6 percent for other small credit unions. The loss ratio (net charged-off loans to loans made since organization) of limited-income credit unions was 0.39 percent compared with 0.42 percent for other small credit unions. Cargill noted three sources of bias that led to an understatement of the loss ratio for all credit unions, but probably especially for the limited-income credit unions. First, credit unions are not required to write off delinquent loans after some specified period of time. Thus limited-income credit unions might avoid writing off loans that are clearly losses to hold down their reported loss ratio. Second, the loss ratio is understated for expanding credit unions and those only a few years old, because the losses have not yet been realized on new accounts, although those accounts still constitute the base for the loss ratio. Third, the actual loss experience of limited-income credit unions is understated, because the losses of those that have been liquidated are not included in the data. With a fairly high attrition rate and presumably heavy losses among the limited-income credit unions now excluded from the data, this method of calculating the loss ratio introduces a fairly serious bias.

Cargill concluded his extensive evaluation of limited-income credit unions as follows:

> The growth potential of the limited-income credit union does not look encouraging, especially if the objective is to establish financial institutions that can become economically self-sufficient. The main difficulties lie in the characteristics of the "common bond" of limited-income credit unions: low income, high mobility and susceptibility to economic misfortune, such as unemployment due to layoffs or health are characteristics of the potential memberships that make it difficult for these credit unions to attract and maintain equity capital and build up a liquid loan portfolio. Combined with a lack of donated labor and office space, the economic outlook for limited-income credit unions in general does not look encouraging, in spite of the substantial funding by the OEO.[22]

Although the conclusion is persuasive based on the evidence in the study, a significant number of customers of limited-income credit unions did pay their debts. If the current mixture of those who repay and those who default cannot be economically served (even with substantial OEO support), it still may be possible to provide cash credit in poverty areas if consumers who repay can be separated from those who do not or if legal rate ceilings are raised so that credit revenue can allow profitable operation.

The Commission funded a study by Ronda S. Paul, Purdue University graduate student, to determine the feasibility of developing a credit scoring system applicable to low income consumers.[23] She examined almost 800 accounts drawn from four OEO-sponsored Community Credit Unions serving Washington, D.C. low income areas. Using data provided by application forms used by these credit unions, she employed a variety of statistical techniques to determine whether the data could be used to develop a credit scoring system applicable to low income consumers. She also tested credit scoring systems of finance companies and a bank in the area to see if they were effective in distinguishing accounts known to be good or bad. Unable to develop a credit scoring system with predictive power, she concluded that the typical credit application form provided information useful for making credit decisions about more affluent consumers but that much of the information sought was not relevant for low income consumers. She suggested a need for variables to measure (or serve as proxies for) psychological attributes such as future-orientation, sense of commitment to obligations, stability, or awareness of events outside the immediate environment. For example, information possibly useful could be club and church affiliations, possession of optional insurance, enrollment in optional training or educational programs, and magazines or newspapers read.

The Commission believes a fruitful area for research by the proposed Bureau of Consumer Credit would be exploration of such variables in an effort to develop viable credit scoring plans to permit credit grantors to be more selective in extending credit in poverty areas. Given adequate rate ceilings and effective credit scoring systems, private cash lenders might be attracted into poverty areas to compete with credit retailers.

Proposed programs

Most problems are approached either by dealing with their symptoms or by attacking their causes.

Dealing with symptoms. Current private and governmental efforts to deal with problems of credit and the poor have largely dealt with symptoms. Credit grantors have been exhorted to offer more credit to the poor. Where such programs have been undertaken much has been learned but often at considerable expense. Some carefully controlled experimentation should continue, but exhortation alone is no way to deal with the basic problem. Governmental subsidy programs involving low income credit unions have not yet resulted in self-sustaining units.

Another version of the subsidy approach would be to establish a program similar to the various federally assisted housing programs. Tempting as this approach might be, it has the same basic deficiency of dealing with symptoms rather than causes. The nature of the risk on

consumer loans and FHA-insured and VA-guaranteed mortgages is different in one big respect: in the case of consumer credit there is often no asset to secure repayment of the debt. Even if there were an asset—a refrigerator or washing machine—society might frown on a government-subsidized lending agency repossessing a necessity from a low income family. Nor is it likely that the public would accept garnishment or other collection remedies, whether employed by the original lender or by the government agency which succeeded to the debt. In short, a consumer loan guarantee or subsidy program could well become merely an indirect way of providing needed welfare payments, but without a consistent decision-making structure to provide funds to those who need and deserve them the most.

Too, there is every likelihood that the subsidy beneficiaries would come to regard their borrowings as supplements to welfare payments. This has been recognized by George A. Wiley, director, National Welfare Rights Organization (NWRO):[24]

> It is our belief that one of the problems we might have, say if NWRO got a grant from the Federal Government or from some agency to insure payments, our local groups or our local people might say, "Let National do it. Let the Government pay it;" and would therefore not feel as responsible for following up on the bills.
>
> So we have felt that kind of an insurance plan might not be the most desirable way to approach this.

Experimental Loan Program—Consumer Credit Assistance Agency

The Commission recommends that Congress establish a pilot consumer loan fund and an experimental loan agency to determine whether families whose incomes are at or below the Federal Guideline for Poverty Income Levels issued annually by OEO have the ability to repay small amounts of money which they may need to borrow.

This experimental program should be carried out by the BCC for a 3-year period from a special BCC office—the Consumer Credit Assistance Agency (CCAA). For the experiment, the CCAA should select two sites for loan offices in one populous city. In addition to continuous monitoring by the BCC, the program should be frequently examined by an advisory committee consisting of representatives of the public, government, and the credit granting industry. Loan size should be limited to a $300 maximum. All loans should be made at the lowest possible APR's and in no case should APR's exceed guidelines drawn by a Commission staff study.[25] Loan maturities should not exceed 12 months and no loan maturity should extend beyond the life of the CCAA. Collection practices should be limited to activities approved by the Commission (Chapter 3).

Because of substantial start-up expenses, the first year's costs and expenses can be expected to exceed income substantially. The third year, when the CCAA will have only enough staff to collect outstanding loans and liquidate operations, can also be expected to reflect deficit operations. It will be the second year of CCAA's existence—a period of stabilization and income generation—which will test the viability of a low income lending office under the CCAA experiment.

In view of the costs connected with establishing loan offices and the risks attendant in making loans, *the Commission recommends that $1.5 million be appropriated for an experimental low income loan program to be allocated among operating expenses, loss write-offs, and loan extensions according to guidelines developed by the advisory committee to the BCC.*

Establishment of this experimental low income lending program should generate the following information:

1. degree of demand that exists for this type of loan;
2. actual costs of providing such loans;
3. consumers' reasons for borrowing;
4. demographic characteristics of borrowers;
5. repayment patterns of consumers; and
6. types of creditors' remedies necessary for effective collection.

The Commission believes these data can help determine whether the market served by the experimental agency can be economically served at reasonable rates.

The data gathered should provide perspective on repayment habits of low income credit applicants who need cash loans. More specifically, the data should provide insights into circumstances which underlie the payment or nonpayment of loans. Coupled with basic demographic characteristics of the borrowers, repayment patterns could be utilized to develop credit scoring systems applicable to low income borrowers in that area. Those systems could then be used as a beginning for development of similar systems for borrowers with similar characteristics in other low income areas of the country.

In sum, the Commission believes that establishment of the pilot lending program will enable private industry and government to assess their respective roles in serving the low income direct loan market.

Treating causes

There are signs that some of the root causes of inaccessibility of credit to the poor are being mitigated. From 1959 to 1971 the proportion of families classified as below the poverty level fell from 22.4 percent to 12.5

percent. While this statistic is surely not heartening to the 25.6 million families and unrelated individuals still in the poverty class, it does signify that the many Federal and state programs designed to reduce poverty have had some success.[26]

Despite the progress made, the remaining problems of dealing with low and unstable incomes become progressively more formidable. The Commission believes that full access to the legal credit market by the poor will be effectively provided only by improving their incomes. The basic problem of the poor is that they do not have the same ability to repay obligations as other consumers. Restricted access to the legal credit market is only one of many results of an unstable or inadequate income. The solution lies not in glossing over the symptoms but in dealing with the major causes.

Once consumers have an assured level of cash income and freedom to allocate it according to their personal value systems, they will gain greater access to the credit market. Present access to credit by consumers living at poverty levels can be improved only to the extent that they can be reasonably expected to be able to repay. In most cases, the root cause of their inability to obtain credit can be met by programs to improve their incomes plus some assistance from effective educational programs (Chapter 11). If other recommendations by the Commission are effected to bring about a competitive market for consumer credit, low income consumers should be able to obtain credit at a price and in an amount consistent with their improved credit standing.

The Commission recommends continued experimentation by private industry in cooperation with Federal, state, and local governments to provide credit to the poor. It commends firms that have undertaken such endeavors. More carefully controlled experimentation on the part of Federal agencies could also produce useful results. *The Commission recommends that legislation permitting "small small" loans should be encouraged as a suitable means of providing loans to the poor from regulated, licensed lenders.* Despite high rates of charge, the legislatures of at least eight states[27] found such legislation an acceptable alternative to the loan sharks found in many other states.

Over the long run, however, the problems of credit and the poor can be met only by dealing with the major reasons that people are poor.

Conclusions

Anecdotal evidence has convinced the Commission of widespread instances of unwarranted discrimination in the granting of credit to women. By awakening the credit industry to the understandable objections of women through its hearings in 1972, the Commission believes that competition among credit grantors would remedy many of the problems set forth. While not recommending legislation at this time, the Commission urges close surveillance by the BCC of discriminatory practices. It should publicize abuses, thus insuring their elimination. If this should not prove effective, corrective legislation could be considered.

The Commission did not find sufficient evidence to prove the hypothesis that there is racial discrimination in the granting of consumer credit. Evidence does suggest that creditworthy consumers living in poverty areas have severe problems in obtaining credit, problems largely associated with the difficulties creditors have in collecting debts in certain areas of inner cities. Whatever their basis for selection of customers—sex, race, residence, marital status, nature of employment, age, and so on—creditors must be certain that the differentiations they make among consumers as to their credit standing are based on sound, *provable* experience or actuarial statistics. Adoption of the guidelines for a rate ceiling structure described in chapter 7 should enable loans to be made on these bases in poverty areas along with the encouragement of further experimentation by government in cooperation with all segments of the consumer credit industry.

Finally, the basic problem of providing credit to the poor is not a credit problem but an income and employment problem. The Commission urges treatment of the basic causes—income improvement programs, upgrading of neighborhoods, and education—in addition to efforts to make credit from legal sources more widely available.

Chapter 9

FEDERAL CHARTERING

Section 404 of Title IV of the Consumer Credit Protection Act (CCPA) charged this Commission to study "The desirability of Federal chartering of consumer finance companies." In undertaking this assessment, the premises of legislative intent had to be clearly defined. Webster's Third International Dictionary defines a charter as "an instrument in writing from the sovereign power of a state or country granting or guaranteeing rights, franchises, or privileges." In contrast to a license, a charter conveys broader powers which can be exercised over a long or even an indefinite period of time. In the consumer finance field, licenses typically grant a fairly narrowly defined set of powers and often must be renewed annually. Instead of opting for chartering or licensing exclusively, the Commission prefers to keep both alternatives available if workably competitive markets do not develop from implementation of Commission suggestions.

At the time of CCPA passage, "consumer finance companies" could have been taken to mean "licensed lenders" or small loan companies. Even then the precise identification of such firms was blurred. In about 14 states companies operated offices under ancillary acts which permitted them to make loans significantly larger than they could under small loan statutes. A number of licensed lenders had already diversified into other lines of consumer credit and into various forms of business credit. Many sales finance companies had opened or acquired loan offices. The changing character of the business was officially recognized in 1970 when the Board of Governors of the Federal Reserve System (FRB) stopped distinguishing between sales finance and consumer finance companies in its statistical reports and listed these firms under the heading, "finance companies." This chapter, therefore covers finance companies with broadly defined powers including, but not limited to, the right to make direct cash loans as well as to purchase various types of consumer paper.

Precedent for dual chartering

Dual chartering is a means of providing more than one route of entry into a business. The separate paths of finance company entry utilize Federal or state charter but not both.

Several types of financial institutions but not finance companies offering consumer credit can choose to operate under either a Federal or a state charter. They may take demand deposits or savings accounts. Finance companies generally may not. Several state-chartered commercial banks were operating prior to 1791 when the first Federal charter was issued to the First Bank of the United States. The National Currency Act of 1863 and the National Bank Act of 1864 firmly established a Federal alternative to state-chartered commercial banks. Credit union charters became available under the laws of New Hampshire and Massachusetts in 1909, but it was not until 1934 that the Federal Credit Union Act was passed to permit the granting of Federal charters. Although savings and loan associations are not yet extensively involved in extending consumer credit, they also can choose between Federal or state charters. As with commercial banks and credit unions, state charters for savings and loan associations preceded Federal charters.

The extent to which federally chartered institutions must adhere to state law is not entirely clear. The National Bank Act specifically provides that national bank interest rates may not exceed rates permitted for state banks by the applicable state laws.[1] State laws also determine the power of federally chartered banks to branch, either *de novo* or by merger. Similar restrictions are not imposed by law on federally chartered savings and loan associations although the Federal Home Loan Bank Board (FHLBB) usually, but not always, follows the state law guidelines. It has been held that Federal credit unions are not bound by state laws limiting finance charges. The issue was met in an opinion of counsel, Federal Deposit Insurance Corporation (FDIC), regarding the right of Federal credit unions to charge an annual rate of 12 percent even though the constitution of Texas limited the maximum contractual rate to 10 percent:

> The provisions of the Texas constitution and statutes fixing the maximum rates of interest which

may be charged in that state are not applicable to or binding on Federal credit unions as the Federal Credit Union Act is controlling in this respect. Federal credit unions complying with Section 7(5) of the Federal Credit Union Act in charging interest on loans to their members cannot be said to be guilty of usury under the Texas usury laws even though the rate of interest so charged is in excess of that limited by Texas law. The Texas Loan Shark Injunction Law cannot be invoked against such Federal credit unions for charging interest in conformance with the Federal Credit Union Act, as by doing so, they would not be guilty of charging usurious interest.[2]

Some federally chartered credit unions in Arkansas also evidently charge 12 percent per annum on loans in spite of a state usury limit of 10 percent.

In contrast to the dual chartering alternatives available to these depository institutions, finance companies have always operated under state charters. The first modern enabling legislation was passed in Massachusetts in 1911, and the Russell Sage Foundation built its principles into the first draft of the Model Small Loan Act in 1916. From the beginning, finance companies making cash loans and operating under this Act were also required to obtain a license or certificate of registration—renewable annually—from the state for each office. The state small loan administrator was required—also annually—to examine the loans, books, and records at each office. Sales finance companies that purchase consumer paper have also always operated under state charters and are required to be licensed in some states.

Arguments for Federal chartering

The basic argument for a dual chartering system is presented in the Report of the President's Commission on Financial Structure and Regulation:

> When a particular type of financial institution can be chartered by only one agency—whether state or Federal—a twofold danger emerges. First, the agency may become overzealous in protecting existing firms, with the result that entry by new firms is effectively foreclosed. Second, the agency may not be as innovative and imaginative as it should be in exercising its authority. Opportunities for dual chartering and supervision mitigate these dangers and improve service to the public.[3]

Consumer finance companies that make cash loans, as distinguished from sales finance companies that purchase consumer paper, have been subjected to the two dangers cited: overzealous restriction on entry and prohibitions on innovation. These restrictions have only occasionally benefited some of the companies involved and never consumers. The advantage of Federal chartering or licensing would be to provide the opportunity—but unfortunately not the certainty—of striking down anticompetitive developments. Encouragement of competition is important to consumers because it provides the most efficient means of making credit available to them at reasonable prices. Put another way, competition can eliminate any monopolistic profits of credit grantors and drive from the market the least efficient creditors. If competition can be made to work, the degree of governmental intervention can be limited primarily to the assurance of consumer rights and remedies in credit arrangements (Chapters 3 and 4).

Overcome restrictions on entry. Although chartering is properly viewed as a means of *restricting* entry for depository institutions such as commercial banks, it should be used as a means of *opening* entry to the consumer credit field by institutions not permitted to take deposits. The fundamental difference in philosophy is clearly set forth in the 102nd Annual Report of the Comptroller of the Currency (p. 2):

> The imposition of entry controls through the requirements of a public charter represents the most fundamental structural regulation of the banking industry. In the unregulated industries, freedom of entry is preserved as the essential basis for the reliance placed on private initiative to exploit demands, and generally to make certain that productive resources move to their best uses throughout the economy. It is recognized that free entry may result in the elimination of inefficient competitors, but this is regarded as a small price to pay for the public benefits of private initiative and innovation. Failures in banking, however, are considered to be of greater public consequence than failures in other industries because of the broad effects on confidence in the banking system and the severe incidence on individuals and small business firms. Entry restrictions have thus been adopted as one of the measures for preserving the viability of the banking system.

Until 1932 small loan licenses were available under the Uniform Small Loan Law to applicants who demonstrated "financial responsibility, experience, character, and general fitness." The sharp bite of competition of the early 1930's spawned a change in the Uniform Small Loan Law by introducing the convenience and advantage (C and A) provision:

> If the commissioner shall find. . . that allowing such applicant to engage in business will promote the convenience and advantage of the community in

which the licensed office is to be located... he shall thereupon enter an order granting such application... and forthwith issue and deliver a license to the applicant.[4]

New Jersey was the first state to adopt the C and A clause in 1932; by 1968, 35 states had a C and A licensing restriction.[5]

The requirement is enforced with widely varying degrees of severity. Currently, about six states impose "tight" (few offices in market relative to population) restraints on entry of consumer finance companies and six others "medium" (more offices in market relative to population) restraints.[6]

It is, of course, understandable that firms with licenses try to prevent the issue of additional licenses to potential competitors, just as other cash lenders at times oppose the "free entry" concept for finance companies. Some arguments presented to justify restraints on competition to "benefit" consumers have often been questionable:

> However, it is well to bear in mind that the convenience and advantage clause, if enforced by the administrative authority, insures healthy, well-rounded and dignified small loan service for those of us and our neighbors who need it.[7]

As with this plea, reasons advanced to support restrictive C and A licensing of consumer finance companies have often been specious.[8] Since finance companies are not depository institutions, the Commission cannot support shielding them from the goad of competition. Indeed, the Commission concurs with the analysis of Senator Paul Douglas:

> Restrictions on bank entry have generally been justified in the name of deposit safety. But it is difficult to see what public policy objectives are fostered by a "convenience and advantage" test for finance companies other than perhaps preserving a higher than average level of profits for banks and finance companies....
>
> One can perhaps understand the opposition of bankers and some finance companies to a repeal of convenience and advantage restrictions on entry. Such an action might well jeopardize their monopolistic profits. But it is difficult to understand the opposition of some consumer groups to free entry unless the consumer organizations have been infiltrated by undercover agents for the banks.... I hope that consumer groups across the country support the free entry provisions of the [Uniform Consumer Credit] Code and will insist upon their retention.[9]

A major justification for Federal chartering or licensing would be to permit finance companies, broadly defined, to open offices without being subjected to C and A restrictions on entry. The Commission perceives no significant threat to well managed depository institutions from such free competition which may be an unwelcome aspect of the capitalistic system for some credit suppliers, but not for consumers.

Overcome restrictions on innovation. One of the most effective ways competition serves consumer interests is in the development of new products and services. The practice of making monthly instalment payments was a major innovation for both consumer and mortgage credit. The consumer credit field has provided many other inventive developments: revolving credit, check credit, overdraft banking arrangements, and credit cards.

Unfortunately, all credit grantors have not had equal opportunity to innovate or compete in offering new forms of consumer credit. Finance companies and, to some extent, credit unions have been restricted in ability to compete with other lenders and provide and develop new credit services.[10] These restrictions are partly a heritage of a law designed over a half century ago as an antidote to illegal lenders and partly an attempt by other cash lenders to impede the progress of potential competitors. Some restrictions have also been self-imposed by the industry itself. For example, small finance companies have frequently opposed higher limits on size of loans in fear that they could not obtain the necessary capital to meet the demand. The resulting melange of restrictions has produced a segmentation in the cash loan field that inhibits competition, raising the cost of credit and reducing its availability.

What barriers to innovation might be overcome by Federal chartering? One of the most oppressive restraints is a low ceiling on size of loan. For example, if a high-risk consumer in Florida wants to borrow $1,800 for 2 years, he must seek $600 from each of three different finance companies. By law that amount is the maximum obtainable from any one company. Such a restriction harms consumers in at least two ways. First, because it costs more to provide three $600 loans than one $1,800 loan, the consumer pays the higher costs. The three loans will cost the Florida consumer $186 more than if he borrowed the entire $1,800 from one finance company in Utah, for instance.[11] Second, other lenders able to make larger loans are protected from effective competition by finance companies. Without the potential for invasion of their large loan market, banks, credit unions, and other lenders may provide consumer credit at higher prices than would otherwise be the case.

Restrictions on development of loan programs to meet consumer needs may follow from limits on maturity of contract and from practical prohibitions of renewals, as in Maine. A Commission study[12] indicates that some high risk borrowers were eliminated from the legal market in Maine after a new consumer finance law restricted finance charges to 8 percent per annum if a loan had been on the books for 36 months. Some of those who could not renew their loans turned to other suppliers of credit, such as banks and credit unions. As a result, the number of finance companies operating in Maine declined from 115 in 1967 to less than 16 today. If Federal charters or licenses were available to finance companies under terms that encouraged them to make credit available to less affluent, high risk borrowers, Maine consumers would again have access to cash credit from finance companies and other Maine credit grantors would still be faced with real or potential competition from licensed lenders.

Another barrier to effective innovation by lenders may be abnormally low rate ceilings that prevent them from attempting to serve less creditworthy borrowers. At times rate ceilings have been set so low that consumer finance companies have been driven from the state, leaving low income consumers to the mercies of illegal lenders.[13] The case most commonly cited today is Arkansas where the 10 percent usury ceiling has sharply reduced the ability of cash lenders to create lending programs to meet the needs of customers. One recent study of cash lenders in Arkansas concluded:

> The absence of most of the national small loan companies leaves a greater percentage of the potential small loan business to the Little Rock banks. However, it is doubtful that the banks are actually accommodating many potential small loan customers. Few of the banks, if any, actively solicit small loan business.[14]

These findings are reinforced by the Commission survey of consumer instalment credit outstandings at mid-1971. Arkansas ranked 47th among the states with respect to the per capita mean amount of total consumer credit outstanding and 44th in terms of per capita bank credit outstanding. If the federally chartered finance companies need not comply with the state usury law—as in the case of Federal credit unions—Federal chartering would permit deserving Arkansas consumers to gain access to credit now denied them.

Finally, existing state laws restrict the variety of credit-related services that finance companies may offer consumers. Generally, they may not provide revolving credit, although competing banks and credit unions may. In some states they are prohibited from operating a "dual business"—making cash loans and purchasing instalment paper at the same location. They may be hampered by "brick wall" provisions that prohibit selling goods and services and also making of loans on the same premises, although competitors are so permitted this privilege. The end result of these restrictions is to limit innovative efforts to offer a broad spectrum of consumer money management services. Whether operated by banks, finance companies, or other credit grantors, these represent a means of providing "one-stop shopping" for consumers for investing funds and obtaining a wide variety of credit services. Federal charters or licenses could be designed to test the attractiveness to consumers of money management centers where they could get financial advice, purchase insurance, invest in mutual funds, and obtain credit of all types, including mortgage credit.

Arguments against Federal chartering

In some respects it is easier to marshal arguments for Federal chartering than against it because defects in the present system (without Federal chartering) are evident. A system *with* Federal chartering would also have its failings, but at this time they are hypothetical.

Consumer credit a local function. Congress made Federal charters available to encourage the growth of savings and loan associations and credit unions. Indeed, the most rapid expansion of credit unions dates from the passage of the Federal Credit Union Act in 1934. But except for credit unions, depository institutions now having dual chartering often grant credit to business firms and consumers far removed from the locale where they obtain their savings. As depository institutions and credit grantors operating on a fairly wide geographical scale, commercial banks and savings and loan associations are endowed with a large measure of national interest.

It is doubtful that this kind of national interest applies to finance companies. Typically, a finance company office provides credit to consumers living within a fairly constricted geographical area, sometimes as small as a few city blocks. Since they are not permitted to accept either demand or time deposits, they are not affected by the public interest as much as banks, savings and loan associations, and credit unions. Finally, there is no evidence that Congress has the same sense of commitment to the well-being and growth of finance companies as it has demonstrated for those depository institutions now offered a choice of state or Federal charter. A healthy legal environment would be a "must" if federally chartered finance companies were to be viable institutions for meeting consumer demand for credit in the higher-risk market. As a minimum, enabling

legislation would have to give federally chartered finance companies the same relative authority and protection accorded by existing statutes to other federally chartered financial institutions; otherwise, a Federal charter would be an empty privilege.

Further segmentation of consumer credit market. To assure equal treatment of consumers it is desirable to have all credit grantors subject to the same set of rules and regulations. One of the deficiencies of the existing legal system is that consumer credit is subject to a wide and rather haphazard variety of laws within most of the states. Unless Congress is prepared to pre-empt all state consumer credit legislation as an accomplishment to Federal chartering, it is possible that the creation of federally chartered finance companies would merely add one more tier on the supply side of a market that is already too complex and segmented for consumers' best interests.

In Chapter 7 the Commission recommended striking down artificial legal barriers to competition that have been erected among different suppliers of credit rather creating new ones.

Further fragmentation of regulation. The Commission expressed its disenchantment (Chapter 4) with the current uneven enforcement of existing state and Federal laws regulating consumer credit which magnifies the uneven treatment accorded consumers under present legislation. It seems likely that the current fragmented and inconsistent supervision would only be exacerbated by creation of still another type of credit grantor chartered at the Federal level. Obviously, unequal enforcement of Federal and state laws designed to protect consumers does not necessarily follow a system of Federal chartering. But until remedies are found to meet the problems of those institutions currently under a dual chartering system, it seems unwise to create a situation where consumer protection may be further weakened.

There is some evidence of Congressional intent in this respect. Section 123 of Title I (Consumer Credit Cost Disclosure) of the CCPA provides that the FRB may exempt from the requirements of that chapter:

> any class of credit transactions within any state if it determines that under the law of the state that class of transactions is subject to requirements substantially similar to those imposed under this chapter, and that there is adequate provision for enforcement.

If Congress was willing to give priority to state regulation, once it complied with Federal minimum standards, Congress might also prefer to let the chartering of finance companies remain in the hands of the states.

Evaluation of Federal chartering

The Commission recognizes that the market for consumer credit is not a perfectly functioning mechanism. Although imperfections may be insignificant in the low- and medium-risk portions of the market, they are too prevelant in the high-risk segment of the market and possibly in some rural and geographically isolated communities as well. There appear to be two approaches to deal with observed market imperfections. One is to strike at the root causes of the imperfections by removing from state and Federal legislation any barriers to entry, to innovation, and to effective competition, especially in the high-risk market. Such fundamental changes, discussed more fully in Chapter 7, include recommendations to facilitate the penetration of banks, credit unions, and savings institutions into the high-risk segment of the consumer credit market.

An alternative approach would be to provide for Federal chartering or licensing in an attempt to override legal impediments to effective competition in the high-risk market. Federally chartered finance companies may be able legally to ignore restrictive state laws that inhibit competition in consumer credit. But such possible gains may be more than offset by creation of a new bureaucracy that further emphasizes existing market segmentation and provides opportunity for more fragmentation of supervision.

For now, the Commission believes that Federal chartering of finance companies should be held in abeyance while pursuing two complementary courses of action. First, efforts should be undertaken to persuade the states to remove from existing laws and regulations anticompetitive (and, by extension, anticonsumer) restrictions on entry and innovation. Possibly the Justice Department could intervene as it did when state pharmaceutical boards attempted to prevent druggists from posting prices of standard prescriptions. Similarly, there appear to be grounds for arguing that less affluent consumers in Arkansas have been deprived in a discriminatory manner of their rights to obtain credit.

Second, Congress should sustain the research initiated by the Commission, possibly through the BCC recommended in Chapter 4. Competitive conditions in states which persist in restricting entry of finance companies under convenience and advantage legislation and in jurisdictions which inhibit innovation by consumer credit industry firms should be the subject of continuing

study. Other research should examine directly the adequacy of competition in isolated communities--so called "one-bank" towns--to determine whether residents in those areas obtain adequate amounts of consumer credit at reasonable prices. The effect of the present fractionalized legislation and regulation upon consumers should be reviewed as well as the progress of efforts to enact state consumer credit legislation. Enactment of consumer credit legislation of the type recommended in this report (Chapters 3 and 7) should be also reviewed to determine whether any added amendments inhibit the basic aim of ensuring free entry of firms and fair treatment of all consumers. Should this research demonstrate that the states are not fostering an environment in which consumers have access to a wide variety of competitive financial services, that progress of consumer credit legislation at the state level is too slow, and that overall Federal legislation is deemed infeasible, then the Commission recommends that Congress undertake Federal chartering of finance companies in a manner designed to remedy these deficiencies in the market for consumer credit.

The essential elements of Federal chartering

If the Commission's substantive portions of the recommendations regarding workably competitive markets are not enacted within 4 years, and states have not eliminated barriers to entry (C and A laws and loan size ceilings), then Congress should charter national finance companies utilizing the BCC as the chartering and supervising agency. Commission recommendations are aimed at making national finance company credit available to consumers at reasonable rates by permitting such firms freedom of entry and innovation assuming aforementioned arguments against Federal chartering are satisfied.

A supportive posture

It is assumed that the BCC proposed in Chapter 4 will be empowered by Congress to issue Federal charters to finance companies. Such charters might be granted with the proviso that national finance companies could operate only in those states where the BCC determines competition is inadequate. Since the objective of Federal chartering would be to foster more effective competition, Congress should charge the BCC by statute with responsibility for actively supporting the growth of the national finance companies. Unless federally chartered finance companies receive from Congress the same support as Federal credit unions and Federal savings and loan associations, the competitive benefits for consumers will not be substantially realized. Specifically, the BCC should be required to assure an adequate and expanding supply of credit at reasonable rates, particularly to low income consumers.

Powers of entry and innovation

Where competition is so inadequate that the supply of credit is restricted or unavailable at reasonable prices, the BCC must make its Federal charter more attractive than a state charter or the Federal charter availability will be a hollow threat to credit grantors who enjoy monopolistic positions in the state. Federally chartered and supervised firms must be able to supersede state laws in three crucial areas: entry, rates, and the forms and terms of consumer credit offered. However, state laws relating to creditors' remedies and debtors' rights should govern the operations of a national finance company within the state.

Entry. Federally chartered finance companies should not be restricted in their entry privileges by state C and A legislation applying to finance companies. In the dozen or so states which now restrict entry, this provision might encourage the entry of new firms, offer the possibility of making more credit available and reduce its price.

Rates. The Commission believes that Congress should charge the BCC with establishing reasonable rate ceilings for federally chartered finance companies. In establishing rate ceilings the BCC should consider the guidelines set out as Commission staff suggestions in Chapters 6 and 7.

Forms and terms of consumer credit. Federally chartered finance companies should not be limited as to amounts and maturity of credit granted and should be permitted to experiment with a wide variety of forms of consumer credit. Whether operated independently, as part of a bank holding company, as a subsidiary of a seller of goods and services, or as a subsidiary of a finance company, a federally chartered firm should be empowered to offer whatever mixture of financial services its consumers need. Federally chartered finance companies should not, at least in initial stages, be permitted to take deposits.

The BCC should not have the power to establish minimum downpayments or to limit maximum maturities for consumer credit transactions as a form of economic control. If monetary policies require such regulations, the FRB should initiate them. Congress may wish to place obligation to enforce such limitations with the BCC.

Supervision

Establishment of still another federally chartered institution raises the problem of the powers of the state to ensure compliance with its laws by a national finance company. If it becomes necessary to provide for Federal

chartering of finance companies, the Commission believes that enabling legislation should clearly state that national finance companies must abide by state laws governing creditors' remedies and debtors' rights.

The question as to how compliance with these state laws can be assured has a number of answers. Rather than decide on one method of supervision for a financial institution still in the theoretical stage, several alternatives have been considered by the Commission. Whatever supervisory procedures are finally adopted, the Commission believes they should apply equally to all federally chartered financial institutions providing consumer credit.

One possibility would be to assign state officials the right and power to examine national finance companies for compliance with state laws. A second procedure would be to require examiners of the BCC to enforce compliance with applicable state and Federal laws. Additional assurance could be provided by subjecting national finance companies to subpoena powers, subject to judicial review, by state supervisory and enforcement authorities of records and other evidence at their places of business. A third procedure would be to transfer to the state administrator all or some portion of the BCC's enforcement powers and obligations. At one extreme, qualified state examiners could examine national finance companies for compliance with both Federal and state laws affecting their consumer credit activities. Or there might be provision for a joint examination, with Federal examiners assuring compliance with regulations established in the Federal enabling act and state examiners, under supervision of the Federal examiner-in-charge, ascertaining compliance with state laws. The state agency should be reimbursed by the BCC for its examiners' time and expenses at the rates of compensation applicable to Federal examiners.

Summary

Both the charge by Congress to the Commission and the precedent of dual chartering of depository financial institutions have initiated a review by the Commission of the desirability of Federal chartering of finance companies. Those state laws restricting entry or otherwise limiting competition and the availability of the forms and amounts of credit desired by consumers are counterproductive. They either raise the price of consumer credit, limit its availability, or—more likely—both.

The inhibiting effects of state legislation and regulation may be met by action at the state level to strike down artificial barriers to entry and by passage of consumer credit legislation designed to assure fair treatment of all consumers through giving all credit grantors equal opportunity to compete. Failing enactment of such state laws, Congress could enact legislation in this area of consumer credit. Failing adoption of desirable state laws or Federal laws, *the Commission recommends that Congress should, after passage of the 4-year time period, permit Federal chartering of finance companies with powers to supersede state laws in three of the basic areas where state restrictions now sometimes severely limit competition and availability of credit: limitations on entry, unrealistic rate ceilings,* and *restraints on amounts and forms of financial services offered consumers.*

Federal chartering is one of several possible approaches to deal with deficient competition in the higher-risk market for consumer credit and in geographically isolated markets. It is not the commission's first choice. But Federal chartering will become desirable in 4 years if states fail to remove from existing laws anticompetitive and anticonsumer restrictions on entry and innovation, and if legislation enacted fails to provide consumers with a wide range of risk access to a variety of competitive financial services. If after 4 years it becomes apparent that states are unable to eliminate barriers to effective competition, the Commission recommends that Congress allow the chartering or licensing of national finance companies, through the BCC, following recommendations set forth by the Commission to insure the effectiveness of such companies.

496-072 O - 73 - 13

Chapter 10

DISCLOSURE

As part of its assignment to study "the adequacy of existing supervisory and regulatory mechanisms to . . . insure the informed use of consumer credit" the Commission examined the effectiveness of the Consumer Credit Protection Act (CCPA) and particularly, the impact of Title I (Consumer Credit Cost Disclosure) known as Truth in Lending (TIL). After hearings on H.R. 11601 before the Subcommittee on Consumer Affairs of the House Committee on Banking and Currency, the House of Representatives added to the disclosure provisions of Senate bill 5 (Truth in Lending) sections dealing with extortionate credit transactions and garnishment.

The term "disclosure" in the Act refers to statements and other information which must be furnished to consumers under Title I of the CCPA, including cash price, downpayment, number and amount of instalment payments, dollar amount of the finance charge, and the annual percentage rate (APR). Much of the attention and most of the heat generated by the legislation focused on requirements that the APR be calculated and disclosed.

The Commission studied the background of disclosure legislation, particularly the stated purposes underlying the proposals, and appraised the extent to which the purposes had been achieved. It also looked into possible reasons for lack of complete success and then made recommendations to bolster the effectiveness of Title I.

BACKGROUND

The purposes of disclosure legislation, especially as they relate to statement of the APR, can be best understood by examining the climate in the market for consumer credit which led to demands for disclosure of credit terms and by reviewing the precedents for disclosure at the state level and in other countries.

Climate for disclosure

Prior to enactment of TIL, information given consumers about their credit arrangements ranged from very little to what TIL now requires. Most consumers were told the amount of their monthly payments and the due dates. Provisions for additional information varied widely among credit grantors, types of credit, and states.

The greatest lack of uniformity was in the quotation of the amount and rate of the finance charge. Some credit grantors provided neither figure, showing only the number and amount of monthly payments and the dollar sum.[1] While many creditors disclosed the dollar amount of the finance charge or provided enough data so that it could be ascertained, they stated the *rate* of charge in a variety of ways.

(1) In some cases no rate of finance charge was quoted.

(2) Retailers, finance companies and some banks often quoted the rate as a dollar add-on—an expression of the dollar amount of the finance charge per annum in relation to the *initial* unpaid balance. For instance, the finance charge on a new car loan might have been stated as \$7 per \$100 per year, indicating that on a 3-year loan of \$2,000 the dollar amount of the finance charge was \$420 (\$140 X 3 years). The APR on such a contract is 12.83 percent. Prior to the effective date of TIL, add-on rates were heavily advertised.

(3) Commercial and industrial banks often quoted rates on a discount basis—a statement of dollars per \$100 of initial unpaid balance on the assumption that the finance charge was deducted from the face amount of the note at the time credit was extended. A charge of \$7 per \$100 of initial unpaid balance *discounted* for 3 years is equivalent to an APR of 16.01 percent.

(4) Many consumer finance companies, almost all credit unions, and most commercial banks and retailers offering revolving credit accounts stated a monthly rate applied to a defined balance. Banks and retailers often quoted a rate of 1½ percent applied monthly. If applied to daily unpaid balances from the date of credit extension, as in the case of credit unions, the APR was equivalent to 12 times the monthly rate.

(5) A final procedure was to fragment the finance charge so that part appeared as an add-on or discount rate and part as a flat fee or extra charge. For example, industrial loan companies in Georgia charged 8 percent a year discount (to 18 months) plus a flat fee of 8 percent on the first \$600 of initial unpaid balance. Thus a 6-month loan of \$500 carried a finance charge of \$68.14 or an annual rate of 45.33 percent.[2]

As a result of these varying forms of quoting the rate of charge, consumers could often compare rates among lenders in one class, such as commercial banks, but seldom between classes of lenders, such as credit unions and commercial banks. Interindustry rate comparisons would have been possible only if all segments of the industry used the same basis for disclosing finance rates, whether dollar add-on, dollar discount, percent per month, or annual percent. But because different segments of the consumer credit industry were wedded to various methods of calculating and disclosing rates by historical precedent and in many cases, by state laws, comparison shopping for credit across industry lines was almost impossible. This lack of comparable rate disclosure helped create a climate favorable for legislation requiring uniform quoting of rates of charge.

Several surveys documented the inability of consumers to convert rate statements provided by then existing methods of stating finance charges into APR's. Two studies in the 1950's indicated that about two-thirds to seven-tenths of consumers could not cite APR's on recent instalment purchases.[3] Juster and Shay surveyed *Consumers Union* subscribers in 1960 to determine their knowledge of annual finance rates. Even though the respondents represented a relatively high socioeconomic stratum, "only about 7 per cent of the sample provided reasonably accurate estimates of the effective annual finance rates, and another 11 percent reported rates approximately equal to the add-on or discount equivalent of the effective annual rates."[4] Early in 1969, just prior to the effective date of TIL, the Survey Research Center, University of Michigan, asked respondents:

> Suppose you needed a thousand dollars for a car which you would repay in twelve monthly payments; about how much do you think the interest or carrying charges would be?

Since the question allowed response in terms of dollar amounts or a variety of percentages (annual, add-on, or discount), interpretation of the results is difficult. Seventeen percent could make no reasonable response. Among the 53 percent who cited a percentage rate about three-fourths quoted a rate unrealistically low, unless they were thinking in terms of an add-on or discount rate.[5]

These studies tended to confirm difficulties consumers had in finding a uniform basis for comparing finance charges given differences in amount and maturity of credit. But they did not validate any particular method for expressing the rate of charge. However, the research also demonstrated that consumers frequently underestimated the *level* of the APR's. For example, Juster and Shay found that 28 percent of their respondents thought they had paid 6 percent per annum. Somewhat surprisingly, the "6 percent myth" was held with about the same frequency by their respondents regardless of the rate they had actually paid.[6] This underestimation of consumer credit rates also contributed to a favorable climate for TIL. It seemed apparent that consumers could not intelligently choose between using savings and using credit if they believed rates charged for credit were lower than they actually were.

Precedent for disclosure

Disclosure legislation for consumer credit did not originate at the Federal level. Most state laws required consumer credit contracts to disclose various credit terms depending on the type of credit grantor or form of credit. For example, the Seventh Draft of the Uniform Small Loan Law (1942) provided that:

> Section 11(b) Each licensee shall display in each licensed place of business a full and accurate schedule of the rates of charge upon all classes of loans currently to be made by him.
>
> Section 14(a) Every licensee shall: (1) At the time any loan is made deliver to the borrower, or if there are two or more borrowers to one of them, a statement in the English language, on which shall be printed a copy of section 13 of this Act [a statement of maximum rates of charge and method of computing charges], disclosing in clear and distinct terms the amount and date of the loan, a schedule of payments or a description thereof, the type of security, if any, for the loan, the name and address of the licensed office and of each person primarily obligated on the note, and the agreed rate of charge.[7]

Almost all retail instalment sales acts enacted after 1935 required disclosure of the dollar amount of finance charge, as well as other pertinent features of the agreement.[8] Instalment loan laws applicable to commercial banks were generally less demanding in disclosure requirements.[9]

A few state laws applying only to consumer finance companies required monthly percentages to be expressed as annual rates.[10] Since small loan statutes typically provided for different monthly rates on various levels of unpaid balances, consumers usually received only an impression of the general range of rates rather than a single rate for the particular loan. Some small loan offices in Wisconsin showed a single APR on agreements long before enactment of TIL. As early as 1967, industrial loan companies in Hawaii were required to give borrowers a written statement showing, among other items, "the actual effective date of interest a

year."[11] Early drafts of the Uniform Consumer Credit Code (UCCC) also required disclosure of the finance charge as a dollar amount and as a rate, although the rate was expressed as dollars per $100 of initial unpaid balance per year. However, as approved by the National Conference of Commissioners on Uniform State Laws in August 1968, the UCCC provided for disclosure of the finance charge as an APR and that other disclosures be made substantially similar to those required by TIL.

On January 1, 1967, Massachusetts became the first state to require disclosure of APR's on almost all consumer credit transactions. Although disclosure of the rate was based on the constant ratio formula rather than the actuarial method, the rate statement was equally effective for purposes of comparison shopping and only slightly overstated the actual rate for those consumers wishing to compare the merits of using savings or credit. Testimony asserting that disclosure legislation was workable in Massachusetts was instrumental in securing passage of legislation at the Federal level.[12]

The impetus for disclosure legislation in the United States traveled abroad. By the end of November 1967, seven Canadian provinces had adopted laws requiring disclosure of finance charges as APR's, although in two provinces the statutes had not been put into force.[13] Similar legislation applicable to banks was passed at the federal level.[14] In England a 1964 amendment to the Hire-Purchase Act required that if a finance rate were given in an advertisement, it should be stated as an annual percentage on the declining unpaid balance rather than as the customary percentage of the initial unpaid balance.[15] Evidently, however, the effect of that amendment was to eliminate rate advertising.[16] South Africa's disclosure act became effective April 1, 1969, and required disclosure of an APR on consumer credit transactions.[17]

Senator Paul Douglas first introduced the Consumer Credit Labeling bill (S. 2755) on January 7, 1960. When he left the Senate, Senator William Proxmire introduced and held hearings on a Truth in Lending bill, S. 5. By then a greater awareness of the variety of methods of quoting rates of finance charge had developed. Because experience with rate disclosure at the state level and in foreign countries showed its workability, S. 5 passed the Senate on July 11, 1967. A companion bill, H.R. 11601, requiring disclosure of finance charges in consumer credit transactions and dealing with many additional aspects of consumer credit, was introduced in the House on July 20, 1967, cosponsored by Congresswoman Leonor K. Sullivan and five other members of the Subcommittee on Consumer Affairs. In addition to provisions affecting extortionate credit transactions and garnishment, the final version of the Consumer Credit Protection Act (House title for the bill) included a number of changes relating to disclosure drawn from H.R. 11601. Major additions were:

1. The effective date of disclosure of the APR was changed from January 1, 1972, to July 1, 1969.
2. Disclosure requirements were made applicable to transactions involving extensions of credit secured by first mortgages on real estate. Only the disclosure of the dollar amount of the finance charge in connection with purchase money first mortgages (a first mortgage loan to finance purchase of a dwelling) was not required.
3. Significant provisions were added to govern advertising of consumer credit.
4. The exemption from stating an APR on revolving credit accounts (a compromise provision passed by the Senate) was deleted.

After H.R. 11601 passed the House, a Conference Report was filed May 20, 1968, agreed to in both Houses May 22, and signed into law May 29, 1968.

PURPOSES OF DISCLOSURE

Debate in the United States and abroad concerning disclosure legislation centered largely on the disclosure of the finance charge as an APR. There was little hesitation, though some lack of performance, by the credit industry in disclosing the dollar amount of the finance charge. To evaluate the effectiveness of TIL, the Commission first looked at the expressed purposes of the Act and noted the problems it was not intended to remedy.

Shopping function

As hearings opened on the Consumer Credit Labeling bill in 1960, Senator Douglas pointed out a basic purpose of rate disclosure:

> The benefits of effective competition cannot be realized if the buyers (borrowers) do not have adequate knowledge of the alternatives which are available to them. In my judgment, S. 2755 would invigorate competition in the consumer credit market by requiring a return to price competition. Extra-normal profits earned through the ability to mislead borrowers would be minimized.

Senator Proxmire later emphasized the importance of the shopping function to effective price competition:

> The main thrust of the Truth in Lending bill is to promote more effective price competition in the consumer credit industry. As you know, competition is the essence of our free enterprise system. The

workings of the competitive market insures that consumers will be able to obtain the kinds of goods they want at the lowest possible price.[18]

Unless a consumer shopped for a fixed amount of credit for a specified maturity, it would be almost impossible for him to compare prices of credit from just the dollar amounts of the finance charges. If he were told that an instalment loan of $1,000 for 24 months would cost $113.03 while one for 12 months would cost $60.58 he would not know which had the higher *rate* of charge. In his opening statement at the 1967 hearings on S. 5, Truth in Lending, Senator Proxmire observed:

> The rate is essentially a standard unit price for the use of credit. Many commodities disclose standard unit prices to facilitate comparison shopping. Gasoline is expressed as a price per gallon, steak as a price per pound, and ice cream as a price per quart. There is no reason why credit should be treated differently.

To compare prices of credit the way he compares prices of gasoline, meat, and ice cream, a consumer needs some statement of a time rate. He needs to know, for instance, that a 24-month loan has a rate of $5.65 per $100 of initial unpaid balance while a 12-month loan has a rate of $6.06 per $100 of initial unpaid balance or—in TIL terms—that the 24-month loan carries an APR of 10½ percent and the 12-month loan a rate of 11 percent. This does not imply that a consumer will, or should, select the loan with the lower time rate (but, in this case, with the higher dollar finance charge). For any number of reasons he may select the loan with the higher rate, but he should have time-rate information available as a basis for his decision.

Congresswoman Sullivan remarked at hearings on H.R. 11601 in 1967 that the purpose of disclosure was not necessarily to reduce consumer use of credit but to help consumers avoid high-cost sources of credit. She said:

> Undoubtedly, we are fighting in behalf of people who, in many instances, could not care less what they have to pay. All they want to know is how much they must pay a month. But I think sometimes we have to protect people from themselves. And if they are given an honest and full account of what it costs them to buy on credit, they might begin to shop more intelligently. It is not going to stop them from buying. However, it might stop them from going to the person who is going to gouge them on the credit terms.

Since rate disclosure would "permit consumers to shop as carefully for credit as they shop for merchandise,"[19] two results should follow in a reasonably competitive market. First, as suggested by Senator Douglas, consumer credit rates in general would be lowered if the variety of disclosure practices allowed abnormal profits. Second, under the possibly lowered rate structure, each consumer should be able to find a fair and equitable credit price in relation to the other aspects of his particular credit need.

Descriptive function

In the words of Senator Douglas: "The central purpose of the truth-in-lending bill is to prevent the excessive and untimely use of credit by consumers which arises out of ignorance of the cost of credit." The chief aim of the descriptive function of disclosure was to help consumers make more informed decisions about use of credit after comparison shopping to find the best buy. Given the necessary data, consumers should then be permitted to make their own credit decisions.

According to Congresswoman Sullivan:

> . . . We are not going to stop people from wanting things they cannot afford, but at least when they do buy it they should know what it is going to cost them and what percentage of the cost they are going to have to pay for using somebody else's money to satisfy their wants on credit.

What are the consumer's choices? First, he can use credit under the most attractive terms he can find by shopping the market. Second, he can minimize or avoid incurring debt by using some portion of his liquid assets. Third, he can postpone, possibly indefinitely, buying the good or service. The objective of TIL's descriptive function is to help the consumer weigh each of the latter two alternatives against the first—use of available credit.

Credit versus use of liquid assets. A 1959 study of aggregate personal debt and liquid assets showed that 43 percent of spending units (individuals or families) had both debt and liquid assets. Of spending units with some debt, just under one-third had sufficient liquid assets to repay all their outstanding debt.[20]

Why should consumers retain liquid assets—in many cases greater than their outstanding debts—when the return on liquid assets is almost always less than the rate charged for credit? In the past a significant proportion of consumers have viewed this behavior as entirely rational. Of consumers able to categorize this behavior in response to a questionnaire in 1967, over two-thirds favored this decision.[21] The most frequently cited

justification was to keep bank accounts available for emergencies.[22]

One purpose of TIL's descriptive function was to make the choice between use of liquid assets and credit more meaningful. As Senator Douglas noted, a comparison of alternatives could be made only if finance charges on consumer credit were stated as an APR, since rates on savings accounts and other liquid assets were generally available on an APR basis.[23]

Credit versus delayed consumption. A second objective of TIL's descriptive function was to enable consumers to judge "more rationally" whether to use credit to acquire a good or service or to postpone their consumption—perhaps indefinitely, or at least until they had saved enough to make the purchase at a later date. For example, during hearings on H.R. 11601, Congresswoman Sullivan asked:

> Would it not perhaps be better in some cases if the knowledge of the actual full cost of credit that has to be paid on an item did discourage some buying—that is, by some of those who overbuy, and buy when they really cannot afford the object that they are buying?

A significant thought running through the TIL hearings was that consumers could better judge present versus postponed consumption if they knew the APR. It was argued, for example, that most borrowers from credit unions were unaware that 1 percent a month was equivalent to 12 percent a year and "would be shocked by it."[24] It was believed the shock effect might cause postponement of the use of credit.

Of course, usefulness of disclosure of the APR and the dollar amount of the finance charge depends largely on the nature of the decision faced by the consumer. If he is buying a inexpensive item on credit to be repaid in a short time, disclosure of the dollar amount of the finance charge may be more helpful than the APR. For example, if an electric iron has a cash price of $10, but can be purchased for $1 down and $1 per week for 10 weeks, the amount of the finance charge is only $1. But the APR on the transaction is about 102 percent. If the consumer wants the iron now rather than in 10 weeks he probably would find it more meaningful to weigh the time utility of having the iron today against the $1 finance charge rather than against 102 percent. Although the 102 percent appears to be a startling figure, the consumer could hardly be expected to shop for a lower finance charge to save only 25 cents and reduce his APR to about 78 percent.

However, if a consumer is planning a long-term credit arrangement, the APR becomes relatively more useful to his choice between present and future consumption. A consumer may be told that interest charges on a $20,000, 30-year mortgage at 7 percent will eventually sum to $27,902. How meaningful is that figure in helping a family decide whether to buy a home now or wait a few years? In contrast to the credit purchase of an electric iron where the finance charge is paid over 10 weeks, the interest charge on the mortgage is paid over 30 years. The *present* value of $1 of interest charge to be paid at the end of 10 years (discounted at 7 percent) is about 50 cents; that is, if 50 cents were invested today in an account paying 7 percent per annum, the balance in the account at the end of 10 years would be exactly $1. The present value of $1 to be paid at the end of 20 years is about 25 cents; at the end of 30 years, about 12 cents. Indeed, the present value of the *total* commitment to make monthly payments on both principal and interest discounted at 7 percent is precisely $20,000. Unaccustomed as he is to thinking in terms of present values, the consumer may well be able to balance credit versus delayed consumption better by considering the 7 percent rather than the $27,902.

Congress had two possible approaches to the problem. One was to require both the dollar finance charge and the APR for all forms of credit, thereby permitting a consumer to choose among available bits of information to find those data most useful to his decision. The other was to attempt to tailor the disclosure requirements to the nature of the transaction. Congress wisely favored the former approach. The only two exceptions were designed to deal with extensions of credit like those discussed above: the very small and short term and the very long term.

In 1967, the Senate Committee on Banking and Currency Report on S.5 exempted retail creditors from disclosing an APR if the finance charge was less than $10. This exemption was intended to simplify compliance, particularly for small retail businesses. Because many retailers imposed a fixed minimum charge on instalment contracts regardless of the amount of credit the Senate Committee felt that rate tables could be developed more easily if such transactions were exempted. This provision was later amended by the Conference Committee to exempt from disclosure transactions in which the finance charge does not exceed $5 and is applicable to an amount financed not over $75, or a finance charge not over $7.50 applicable to an amount financed exceeding $75.

The Senate Committee amended the original S. 5 by exempting first mortgage credit because it believed consumers were receiving adequate information in this area. To reflect the views of Members of the House, this was amended in Conference to require purchase money first mortgage lenders to disclose the APR. Because of the practice of charging discounts or "points" on FHA

and VA mortgages, the APR required under TIL was more nearly accurate than the nominal rate previously disclosed.

Economic stabilization function

At the opening of hearings on S. 1740 in 1961, Senator Douglas said the purpose of the bill was to help promote economic stabilization by requiring disclosure of finance charges in connection with the extension of credit. As the hearings continued, two arguments were advanced to support this objective of disclosure legislation, again with emphasis on the disclosure of the APR. First, it was contended that disclosure of the dollar finance charge and APR would help prevent consumers from becoming over indebted. Second, it was said that disclosure of the APR would discourage consumers from using credit during a economic boom and encourage their using it in a depression.

An advocate of APR disclosure to prevent overindebtedness was Edward C. Fritz who argued at the hearings that even where consumers

> . . . did have the truth as to the dollar charges, this did not give them an adequate standard by which they could determine whether or not they were capable of making the payment ultimately.
>
> As strange as it may seem, as some of these cases will develop, the average American citizen, just as you and I is better qualified and more capable of determining his capacity to pay in terms of per cent per annum, even more than in just terms of dollars, which he cannot boil down to a uniform standard.[25]

If APR disclosure could, indeed, prevent consumers from becoming indebted beyond their capacity to pay, the required disclosure would not only benefit consumers directly but would add to economic stability by reducing the incidence of delinquency, repossession, and credit losses in a period of recession.[26] The argument that APR disclosure would reveal to consumers a fluctuating cost of credit, discourage use of credit in a boom, and encourage its use in a depression was presented by Dr. James Tobin, then a member of the Council of Economic Advisers:

> Actually, the cost ot credit is a natural countercyclical influence on the timing of credit purchases and repayments, and the purpose of the bill is to increase the efficiency of this mechanism. The cost of credit normally rises in periods of boom and inflation and falls in periods of recession. This natural cycle in credit charges, reinforced by monetary and credit policy, is a stabilizing force in the economy. High credit costs in boom periods restrain credit purchases; low costs in periods of slack encourage credit buying. These variations in credit costs help to dampen the business cycle.
>
> However, the stabilizing effect of changes in credit costs depends on awareness by consumers that the changes have occurred. If buyers are ignorant of the true costs of credit, they are less subject to influence by cost changes. By increasing consumer awareness, this bill will help to make the cyclical fluctuation of credit costs a more stabilizing influence on the economy. In times of boom, rises in finance charges will be more evident to borrowers, while in periods of relative recession, borrowers will be made aware of the more favorable terms on which credit is then available.[27]

Functions for which disclosure was not intended

Before evaluating the effectiveness of disclosure in achieving the three intended objectives, the Commission noted what TIL was designed to accomplish. Both opponents and proponents of TIL were prone to exaggerated claims that should not be used as standards to evaluate the effectiveness of the legislation:

> It is not too much to say that the strong support of witnesses, public officials, legal aid workers, and consumer representatives for the concept of full disclosure of the rate of finance charges and other aspects of a consumer credit transaction . . . was a "put-on." Many of them knew that disclosure would have only a slight effect on the evils about which they were testifying and agitating; yet everyone acted as if disclosure bills would solve the problem.[28]

Truth in Lending (as distinct from CCPA's Title II and Title III) was not designed to remedy many abuses in the consumer credit market. For example, a problem frequently cited in the hearings was the sale by door-to-door peddlers of overpriced merchandise to low income consumers. A typical instance was the case of the tenement dweller who bought a stroller. "It was \$32. I saw the same thing in a store for \$18, but I don't know how much of the \$32 is for interest or extra markup *because it isn't put separately*"[29] (emphasis added). Since almost all of their sales are on credit, credit vendors catering to the low income market frequently do not state a separate finance charge. In such cases it is obviously impossible for consumers to be made "aware" of the finance charge, either as a dollar amount or as an APR.

But evidence suggests that the principal drafters of disclosure legislation were well aware that it was not a panacea for these problems. Early in the hearings Senator Douglas observed

> . . . . the Truth in Lending bill which is before the committee does not attempt to correct all of these abuses. . . . Although these many other abuses are matters of major concern, it has seemed preferable to severely limit the scope of Federal legislation to the disclosure of true costs of the price of credit, leaving to the States the right of enacting legislation to correct other abuses.[30]

Later Kenneth McLean of the Senate Banking and Currency Committee said, "The horror stories that were very often reported by the press in connection with the Truth in Lending bill were bonafide stories; but I suspect that many of these same things may continue to happen even with annual rate disclosure."[31] In light of these various comments it would be inappropriate to judge TIL effectiveness by determining whether or not abuses cited in the hearings continue to exist.

Nor was TIL designed to fix rates of charge. Quite the contrary. Disclosure of both the dollar finance charge and the APR was intended to provide the means for competition–*not* Congress–to set the rates of charge on consumer credit transactions. For example, according to Senator Proxmire

> The purpose behind Truth in Lending is not to control rates or establish interest ceilings. I do not question the validity of an annual rate of 18 percent on department store revolving charge accounts. Nor do I automatically assume that 36 percent a year on a small, unsecured personal loan is too high. I recognize that there are substantial fixed costs in initiating and processing a loan or credit transaction and that the need to recover these fixed costs will push the rate for financing well above the mythical 6 percent per year for small loans or credit purchases.[32]

The CCPA did, of course, specify that a rate in excess of 45 percent on an extension of credit would be one of the elements of prima facie evidence that the extension of credit was extortionate (Title II). This was intended not as a means of setting rates but as definition of an upper limit of conscionability, much as the Money-lenders Acts in England specify that a rate in excess of 48 percent is prima facie evidence of unconscionability. TIL also requires that creditors offering revolving credit annualize any minimum monthly charge greater than 50 cents. "The practical effect of this provision will be to restrict monthly minimum service charges to fifty cents."[33] Except in these two respects, Congress followed Senator Douglas' opening promise during hearings on S. 2755 in 1960 that "It is not our intention to preempt State authority over the level of rates and charges."

EVALUATION OF EFFECTIVENESS OF DISCLOSURE

The Commission undertook this examination aware that TIL had been in operation only 3 1/2 years and that one of the surveys basic to its evaluation of APR's had been taken only 15 months after the effective date of TIL. Further, it assumed that because a new law is usually accompanied by some sort of "learning curve," full effectiveness of TIL is probably yet to be realized in the areas of Commission examination. It also realized that there exist certain natural barriers to full realization of TIL benefits. Many terms of the credit agreement other than the APR–including the amount of each monthly payment and the maturity of the contract–must be disclosed under TIL. Because these terms, too, are significant to consumers, competition among credit grantors may focus as much on such "nonprice" aspects of their credit offers as on the price of credit. But despite these inherent limitations on TIL's potential effectiveness, the Commission determined to try to evaluate its usefulness to the consumer as an informational and shopping aid and its relation to a stable economy.

Shopping function

It is difficult to evaluate the effectiveness of TIL in facilitating comparison shopping for consumer credit, first because many factors other than price affect consumers' demand for credit, and second, because many variables influence the supply of credit. The Commission began by examining consumers' APR awareness. If consumers are not aware of rates charged them on recent credit acquisitions, they are unlikely to have used the APR effectively in comparison shopping. The Commission next looked at the consumer credit market to test TIL effectiveness. Is evidence from that market consistent with reasonably effective comparison shopping? It then attempted to determine whether incomplete effectiveness of TIL was due to inherent limitations in the market or to deficiencies in the legislation and accompanying regulations, or both.

Consumers' awareness of APR's. The Commission authorized two studies to determine consumer awareness of APR's. One was prepared by Robert P. Shay and Milton W. Schober,[34] the other by George S. Day and

William K. Brandt.[35] The first study is based on analysis of two large nationwide telephone and personal interview surveys conducted for the FRB, one in June 1969 immediately prior to the effective date of TIL and the second, 15 months later. The Brandt-Day study is based on 641 personal interviews conducted throughout California in October 1970, and complements the two FRB surveys.

For the Shay-Schober study a consumer was considered "aware" of the APR if he could recall and quote an APR on recent loans and credit purchases of consumer goods and services within the range of rates commonly charged. Except for revolving credit, no upper limits were placed on awareness zones. The same bases for defining awareness were used by Brandt and Day.[36]

In the 15 months after TIL became effective substantial increases were found in levels of APR awareness. The greatest increase was shown for bank credit cards followed by retail revolving credit and all types of closed end credit. For every 100 respondents in 1969 who did not know the APR or made an obviously inaccurate estimate, only 50 in 1970 showed a similar response on bank credit cards; 68 for retail revolving credit; and 72 for all closed end credit. The relatively greater improvement in awareness among revolving credit users may be due in part to APR reminders on monthly bills. Users of bank credit cards are more likely to be in the upper socioeconomic stratum which generally showed a greater improvement in awareness levels.

But, in October 1970, 62 percent of closed end credit users financing cars, furniture, appliances and the like were unaware of APR's they were charged for recently used consumer credit. Greatest levels of unawareness in closed end credit were found in credit purchases of used cars (83 percent) and appliances and furniture (65 percent). In terms of demographic characteristics, highest unawareness levels were found among those with some high school or less (74 percent), with family incomes under $5,000 (76 percent)--between $5,000 and $8,000 (71 percent), living in poverty areas (84 percent) and blacks (84 percent).

Analyzing the most influential characteristics distinguishing "aware" from "unaware" consumers, Shay and Schober found that those least aware were most likely to have low incomes, to have completed high school or less, and to be black. Although other factors were important, depending on the type of credit, these variables most frequently distinguished those who were aware from those who were not. The survey of five types of closed end credit showed educational level to be the single most powerful dividing factor in two cases and of second-level power in two other cases. Obviously, these characteristics are closely interrelated; they are typical of an unaware consumer and are not additive in nature.

What emerges from the two studies is that TIL effectiveness must be evaluated in two quite different markets. Despite areas of overlap, the *general market* includes relatively more consumers with higher educational levels, with family incomes above $8,000, who are more likely white than black, who own homes in nonpoverty areas, and who rely relatively more on cash credit than consumers in the higher risk market. At the other end of the spectrum, the *high-risk market* includes relatively higher proportions of consumers with high school or less education, with family incomes below $8,000, who are more likely black than white, who rent residences in poverty areas, and who rely heavily on credit arranged through dealers.

(1) *The general market.* Even in this market substantial levels of unawareness were found in October 1970. Unawareness levels reported for closed end credit were:

Characteristics		*Percent unaware*
Some college or more		49
Income:	$8,000 - 9,999	63
	$10,000 and more	52
Nonpoverty areas		59
White		58

In terms of fostering viable rate competition among credit grantors, these levels of awareness produced by TIL are probably adequate. Not all consumers need be aware of the APR or shop for credit to bring about effective price competition. A significant marginal group of consumers who are aware and do shop is sufficient to "police" the market. As Senator Douglas pointed out in the House hearings on H.R. 11601:

> . . .it is the undecided minority that influences the sellers. So you need only have, in my judgment, about 10 percent cost conscious and they will get the firms competing for that 10 percent.

An individual creditor cannot know whether a consumer is "aware" or "unaware." If, as in the general market, somewhere between one-third and one-half of the prospects are aware, and if some portion shop for credit, a credit grantor is likely to offer each prospect a given package of credit terms for the same price.[37] Most important, if the price is not competitive with similar packages offered by other creditors, the credit grantor faces the ever-present risk of losing the consumer to a competitor. Indeed, consumers' shopping is supplemented by the comparison shopping of credit grantors.

Credit grantors in the general market must comparison shop if they are to maintain competitive rates because of the threat that many potential customers aware of APR's and differences in rates may shop around for the best rate. In summary then, it appears that 15 months after TIL's effective date a large enough body of consumers in the general market had enough *information* to enforce price competition in that market.

Although knowledge of rates is required for effective price competition, use of such knowledge is also required. To assess fully TIL effectiveness in the general market it is necessary to determine whether consumers were merely aware of APR or whether they also shopped among different sources of credit. Although the Brandt-Day study shows that only one in five consumers considered alternative types of credit sources from among banks, finance companies, credit unions, and retailers, applicability of that finding to the general market is ambiguous. First, that study dealt with responses from both the general and high-risk markets; not just the general market. Second, because "sources" was defined as an alternative *type* of credit (banks versus retailers), the survey did not indicate what shopping occurred among credit grantors of one type.

At best there was a tenuous *association* between knowledge of the APR and shopping. Car buyers, but not durable goods purchasers, who were aware of the APR were more likely to search for credit information than those not aware. Search activity among different types of credit sources characterized buyers of household durables who had a reasonable awareness of the APR on their credit purchases. However, there is no way of determining which direction the causal effect runs. Did awareness initiate search activity, or did the love of searching lead to an awareness of the APR? Although Brandt and Day conclude that *"after fifteen months* Truth in Lending disclosure had not sharply altered the shopping behavior of most consumers," effective competition requires only that *some* consumers shop to police prices in the general market.

(2) *The high-risk market.* The high-risk market is quite different. Shay and Schober identify 21 major problem areas (Exhibit 10-1) and almost every one of those areas falls within what the Commission somewhat arbitrarily defined as the high-risk market. When characteristics of the consumer and the type and source of credit interacted, levels of unawareness ranged from 75 to over 90 percent. Such evidence indicates 15 months after the effective date of TIL, APR awareness had not yet reached many consumers in the high-risk market.

This finding is supported by others. In a study conducted at the Law School of the University of California, Davis Campus, researchers concluded:

> This finding is disturbing. The Truth in Lending Act seems to benefit the richer portion of the population because of their predisposition to be concerned with credit costs rather than the less rich portion whose need for intelligent use of credit is concededly greater ... the Act appears to be of benefit to that class in less need of assistance.[38]

Kenneth McLean reached a similar conclusion:

> Reform in the area of disclosure is certainly needed, but I think it will be the middle income consumer that will obtain the greatest benefit ... now that we have largely solved the problems of middle class America (assuming the States will enact the Consumer Credit Code) I think we still have the peculiar problems with low income consumers. Here I think we need to adopt a rifle shot approach as opposed to a shotgun approach. I don't think anyone has an adequate answer.[39]

Institutional knowledge as a supplement to disclosure. Even though only 38 percent of all consumers using closed end credit may be aware of the APR, and even though relatively few of them use it in comparison shopping,[40] there may be enough to bring about price competition, at least in the general market. The additional shopping fostered by TIL is significantly supplemented by consumers' knowledge of the relative rates charged by credit grantors. This so-called institutional knowledge predates TIL. Recurring exposure to the information provided under TIL must certainly strengthen and refine that institutional knowledge.

The Brandt-Day study suggests that many consumers possess institutional knowledge largely derived from past experience with a particular retailer and credit source. Consumers have a strong attachment to retailers with whom they have dealt previously. Of consumers in the study who previously bought automobiles on credit, 21 percent had patronized the same dealer before; 50 percent of credit buyers of household durables had previously bought from the same retailer on credit.

Reliance on institutional knowledge may help to maintain competition in the marketplace if the knowledge of relative rates of charge is reasonably accurate.

The Brandt-Day study show that 68 percent of consumers know that finance companies have above average rates and that 51 percent know that credit unions have below average rates. Interviews conducted by the Survey Research Center of the University of Michigan reinforce these findings. Asked which source of credit would have the lowest finance charge for the

EXHIBIT 10-1

Problem Areas in Awareness of Annual Percentage Rates on Closed End Credit October 1970

Rank	Problem Group	Percent Unaware
1	Use Autos - Dealer Credit	92.7
2	Home Improvement - Poverty Areas	90.9
3	Appliances - Black	88.9
4	Used Autos - Income under $5,000	87.8
5	Used Autos - Poverty Areas	85.2
6	Used Autos - Banks	85.2
7	Appliances - Poverty Areas	84.8
8	New Autos - Poverty Areas	84.6
9	Used Autos - Black	83.8
10	Personal Loans - Black	82.1
11	Used Autos - Some High School or Less	82.0
12	Used Autos - Finance Companies	80.4
13	Personal Loans - Poverty Areas	80.0
14	Personal Loans - Savings and Loan Associations	80.0
15	Used Autos - Income $5,000 to $7,999	79.9
16	Appliances - Some High School or Less	78.6
17	Appliances - Income under $5,000	78.6
18	Used Autos - High School	76.4
19	Used Autos - White	76.0
20	Used Autos - Nonpoverty Areas	75.8
21	Appliances - Income $5,000 to $7,999	75.2

Source: Shay and Schober, *op. cit.* Chapter III. Based on data from Federal Reserve Board's survey of awareness of consumer credit terms, October 1970.

credit purchase of a refrigerator, 47 percent of the respondents said that the bank would have the lowest finance charge; 33 percent, the credit union; 9 percent, the department store; and only 1 percent, the finance company. The ranking did not seem to be influenced by characteristics such as age and income.[41] As with the Brandt-Day study, the data are biased against credit unions to some extent, because presumably many respondents were not members of credit unions and unfamiliar with their rates of charge. Long before TIL became effective, a Juster and Shay study concluded that "In general, consumers seem to be aware that some classes of loans (automobile, home improvement) are likely to carry relatively low finance rates, others (furniture), to carry relatively high rates, and small loans, to carry higher rates than larger ones.[42]

If past experiences with a retailer or a credit grantor have been satisfactory, and if institutional knowledge is reasonably sound—as it seems to be—consumers understandably may not engage in extensive shopping on each credit purchase. Shopping itself has an economic cost in terms of sacrificed employment or leisure. On credit purchases of low-priced items in particular, a consumer might rationally decide that the expected value of savings gained from extensive shopping is less than the economic cost involved. The Brandt-Day study has lessons for retailers and credit grantors. Given the apparent opportunity for repeat business, especially in selling and financing household items, there are substantial rewards for those who give fair value to their customers.

These findings lead the Commission to believe that pre-TIL institutional knowledge, increased and supplemented by knowledge of the APR is probably sufficient to bring about effective rate (price) competition, at least in the general market. However, as already indicated, price competition is less effective in the high-risk market.

> Many of the benefits of the competitive process apparently do not extend to the high risk sector of the market. When the borrower has few alternatives, he cannot exert the pressure on supplier that is needed to obtain the benefits of competition.[43]

Natural limitations to the effectiveness of TIL, particularly in the high-risk market, were explored by the Commission.

Inherent limitations on potential of disclosure. Inherent limitations on the effectiveness of TIL as an aid to the shopping function relate to characteristics of the consumers using credit and to the nature of the credit transaction. These restraints are particularly strong in the high-risk market, and it is unlikely they can be overcome merely by changes in TIL. Passage of time will give some consumers sufficient experience to use TIL information more effectively; however, criticisms that disclosure has done little for poorly educated low income consumers must be met, in the long run, chiefly by improving their educational and economic levels.

(1) Characteristics of consumers. Many consumers in the high-risk market are rationed in the sense that they cannot obtain as much debt as they would like because of the rates charged.[44] These consumers are more likely to care about the required downpayment and the maturity of the contract as reflected in the size of monthly payments. The Brandt-Day study found that "only one-third of high-income whites considered size of downpayment and monthly or weekly payment important compared with two-thirds of low-income minorities who bought on credit." Because rationed buyers without liquid assets are willing to pay higher rates of finance charge to obtain more credit, they shop rationally by seeking the lowest monthly payment and the longest available maturity.

Consumers with liquid assets above some minimum "safety stock" face a more complex decision involving a trade-off between availability of credit and the difference between rates received on savings and rates paid for credit. They have use for the APR. Probably most consumers with annual family incomes greater than $10,000 are unrationed. If $1,000 is considered a desirable minimum safety stock of savings accounts, certificates of deposit, checking accounts, and government savings bonds, only a fourth to a third of families with incomes of less than $7,500 had enough liquid assets to consider whether to use savings or credit (Exhibit 10-2).[45] Evidence of their rationed status is their less frequent reliance on instalment debt.

No amendment to TIL can remedy this. Consumers caught in a squeeze between low and variable incomes and high costs of supporting their families will be rationed in their use of credit. Being rationed, they will consider aspects of the credit transaction other than price. TIL improves the market by requiring disclosure of all pertinent credit terms, but it cannot be expected that quotation of the APR will cause rationed consumers to shift from shopping for low downpayments and low monthly payments to comparative shopping for price. Until these consumers become more affluent, rate disclosure will not add significantly to their economic well-being.

Another characteristic of consumers in the high-risk market that cannot be remedied by amending TIL legislation is lack of education. The Shay-Schober study found the level of education an important factor, in some cases the most important, in determining APR

EXHIBIT 10-2

Liquid Asset Holdings and Percentage of Families with Instalment Debt, Early 1970

Total family income	Percentage of families with liquid assets more than $1,000	Percentage of families with instalment debt
Less than $3,000	26	19
$3,000 - 4,999	36	31
$5,000 - 7,499	32	52
$7,500 - 9,999	38	61
$10,000 - 14,999	55	65
$15,000 and over	78	49

Source: George Katona, et. al., *1970 Survey of Consumer Finances,* Survey Research Center, University of Michigan, pp. 23, 101.

awareness. The Brandt-Day study also found education most important in TIL awareness, accounting for three-fourths of the explained variations in awareness. Just under one-third of respondents with less than a high school education were immediately aware of the legislation, whereas two-thirds of those with some college education and 77 percent of college graduates were aware. According to the 1970 FRB survey, only 12 percent of those with some high school education or less knew that the credit grantor must specify the APR.

Because APR awareness is necessary to initiate comparison shopping of prices and because awareness of the legislation is needed if consumers are to provide any self-help enforcement of the law, these results explain in large part conclusions that those who might gain the most from TIL have benefited the least. The problem does not stem from the legislation, however, but from characteristics of the high-risk market consumers.

The Commission believes time will bring improvement in the levels of APR awareness. An important question is how much improvement in the awareness levels can be anticipated by the maturation process. Can the remaining unaware consumers be helped to become aware through educational or other programs?

Although data are not available to study the learning and forgetting processes in the high-risk segment of the consumer credit market, the Commission authorized Terry Deutscher, a Stanford University doctoral student, to prepare a study showing changes in awareness in a subsample of credit users taken in July 1971 drawn from a larger sample of credit users interviewed in September 1970.[46] Although Deutscher found "only a very slight improvement in knowledge" of actual APR's on major credit purchases, he observed "considerable improvement" in consumers' knowledge of differentials in rates among various sources—essentially "institutional knowledge." In addition, consumers' awareness of TIL's existence rose over the 9-month period, indicating possibility of more consumer self-help reinforcement of the legislation.

Since the consumers Deutscher interviewed in 1971 were drawn from the same group sampled in 1970, he was able to trace the proportion of consumers who became less aware of the APR charged to finance a television set and the proportion who became more aware over the time span. By July 1971, the level of APR awareness (defined as any rate quoted from 13 to 24 percent) for this hypothetical purchase had risen to 50 percent from 37 percent 9 months earlier. However, examination of the trade-off between "learners" and "forgetters" led Deutscher to conclude that "if there was no change in whatever goes into determining the transition probabilities for learning and forgetting interest rates (such variables, perhaps, as experience with credit or concern over the cost of credit), no further overall improvement in awareness would occur." He also estimated that the proportion of consumers with knowledge of TIL legislation would continue to grow and peak by 1973 at about 67 percent—an acceptable level for awareness of legislation.

These results reinforce the Commission's belief in the need for meaningful consumer education. In arguing for informational and educational programs to reach observed problem areas of APR disclosure, the Shay-Schober study suggests that TIL disclosure of APR's may increase differences in awareness when initial awareness is low, and then decrease differences after some level of awareness is attained. This lag in awareness between the "have nots" and the "haves" must be remedied.

Some consumers of course, cannot or will not be educated. Some will use bad judgment in arranging for credit, just as they will make improvident cash purchases of goods and services. Congress and state legislatures must determine how much additional protection can be provided to keep such consumers from self-damage and at what cost to consumers who shop more wisely for credit.

(2) Nature of sales credit transactions. Another inherent limitation on the effectiveness of use of TIL for comparative shopping is the large portion of consumer credit that is *sales* credit—credit extended in conjunction with the sale of goods and services. About six-tenths of consumer credit outstanding is sales credit although a substantial portion of direct loans is used to acquire goods and services.

Sales credit is much greater in the high-risk market than in the general market. The Brandt-Day study shows that just over half of middle and upper income whites relied on the retailer to provide or arrange credit. In contrast, four-fifths of minority consumers depended on the dealer, and about seven-tenths of low income (under $7,500) whites either used the retailer's charge or instalment loan plan or let the dealer make credit arrangements.

Most of this heavy dependence on dealers for credit by low income consumers results from a dearth of legal sources of cash credit. For example, there are no small loan offices in Harlem or the District of Columbia. There are relatively few low income members of credit unions. An early 1969 survey showed only 7 percent of credit union families had take-home pay—disposable personal income—between $6,000 and $7,500; just 10 percent had disposable incomes of less than $6,000.[48] While 79.5 percent of persons aged 25 or older had not gone to college, only 46 percent of credit union borrowers had

no training beyond high school.[49] These data clarify why Brandt and Day discovered that about two-fifths of their low income respondents did not know whether finance charges at credit unions were above or below average. Direct bank credit is also generally less available in the high-risk market. Only 11 percent of families with incomes between $5,000 and $7,500 and only 3 percent of those with incomes below $5,000 use bank cards.[50]

Because consumers in the high-risk market typically make a joint purchase of goods and credit services, the cost and quality of the household item or automobile tend to dominate the credit aspects of the decision. Exhibit 10-3 shows the percentage of the finance charge to the total time price for a variety of APR's and maturities of contract. At a rate of 18 percent, the finance charge amounts to 9.1 percent of the total time price on 12-month contracts and 16.5 percent on 24-month contracts. These maturities and rates are fairly common on purchases of household items and used cars. Many consumers in the high-risk market concentrate on the amount of downpayment and level of the monthly payment. On a 24-month contract with an initial unpaid balance of $1,000, a doubling of the APR from 8 to 16 percent raises the monthly payment by only $3.73, from about $45.23 to $48.96. If the credit grantor wished to charge 16 percent per annum but keep the monthly payment near $45.23, a lengthening of the maturity from 24 to 26 months would put the monthly payment at about $45.77—an increase of just 54 cents per month.

EXHIBIT 10-3

Percentage of Finance Charge to Time Price by Rate of Charge and Maturity of Instalment Contract

APR	Maturity of Contract (months) 6	12	24	36
8	2.3%	4.2%	7.9%	11.4%
10	2.9	5.2	9.7	13.9
12	3.4	6.2	11.5	16.4
14	4.0	7.2	13.2	18.7
16	4.5	8.2	14.9	21.0
18	5.1	9.1	16.5	23.2

Source: Calculated from *Cost of Personal Borrowing in the United States* (Boston: Financial Publishing Co., 1971), pp. T266-T276.

Not only may the effect of significant differences in APR's on monthly payments be "washed out" by lengthening the maturity of the contract, but some portion of the finance charge may be buried in the cash price of the good or service. This problem is particularly acute in the high-risk market as demonstrated by the Federal Trade Commission in a study in the District of Columbia. In spite of the considerably higher credit risk assumed, finance charges of low income market retailers were only about 4 percent higher than the rates charged by general market retailers (25 versus 21 percent on assigned contracts and 23 versus 19 percent on unassigned contracts). A large portion of the finance charge reflecting the higher risk was buried in the cash prices of merchandise sold:

> On television sets (most of which are the popular 19-inch black and white portables) the general market retailer price is about $130. In the low-income market a customer can pay up to $250 for similar sets. Other comparisons include a dryer selling for $149.95 from a general market retailer and for $299.95 from a low-income market retailer; and a vacuum cleaner selling for $59.95 in the general market and $79.95 in the low-income market.[51]

In spite of charging higher APR's and cash prices than general market retailers, low income market retailers had significantly lower rates of return on stockholders' equity.[52]

In a study on the impact of TIL legislation in Massachusetts, Robert W. Pullen notes the same inherent problem of burying finance charges in cash prices in the high-risk market. He quotes a furniture and appliance dealer:

> . . . this is not only possible but is actually being done in this area by the "borax" outfits, and it is definitely encouraged by the requirement of an annual rate. They sell cheap merchandize at a higher price with as big a down payment as they can squeeze, and advertise terms of 24 and 36 months, *sometimes with no finance charge.* The people buying from them are from the lowest income level, uneducated and unaware of the law, and they are such poor credit risks they can't buy anywhere else (emphasis added).[53]

The foregoing analysis suggests that many consumers, particularly those in the high-risk market, place emphasis on shopping for the good rather than for the credit regardless of TIL information. This hypothesis is

supported by the Brandt-Day study. Even with a fairly broad definition of the ingredients of the credit decision, they found that fewer than 25 percent of consumers considered the set of credit-related decisions as one of the *two* most difficult decisions. More than three-fourths of the respondents regarded the product-related decisions as more important and fewer than 6 percent regarded the choice of credit source as the most or second most difficult decision to make. Nor did need for credit have significant impact on the overall decision process. Brandt-Day concluded their study with this observation:

> Until the credit-related decisions become a more important part of the overall decision process, there is little likelihood that major changes can be expected in consumer credit buying patterns. And since the finance charge represents only a part of the total purchase outlay there is little likelihood that credit shopping and comparison activities will assume greater importance in the future.

Despite consumers' lack of concern with the credit decision, they displayed considerable care in shopping for the item acquired by using credit. Almost three-fifths in the Brandt-Day study considered purchase of a car or household durable for several months or more prior to purchase. After deciding on a particular product, most consumers did considerable searching, with only about a fourth settling quickly on one brand and one store. Because of product dominance in the joint product-credit decision, consumers were only slightly influenced in shopping and deciding on a store by disclosure information. Brandt-Day found that only 6 percent used credit information (including size of downpayment and monthly payments) to compare credit sources.

Neither inherent characteristics of high-risk consumers nor the fact that a large proportion of consumer credit is directly associated with the purchase of a good or service is something that can be changed by amending TIL to improve the shopping function. Unless the gross inconvenience of buying goods and credit services at separate establishments is forced upon consumers by legislation, the nature of the product will continue to govern these joint decisions. Nor does this represent "irrational" behavior on the part of consumers. The dominance of the cash price in the total time price, the scarcity of legal cash credit, and the ability of retailers serving low income consumers to blur the level of the finance charge by stretching maturities or raising cash prices, causes these consumers to place little reliance on the disclosed APR in their shopping. Because of economic and other personal handicaps and the complex decisions they face, they might be expected to expend no shopping effort. Yet Brandt and Day found that a large proportion of consumers *do* plan purchase of consumer durables and shop among alternative suppliers with some care.

Descriptive function

Is there evidence to suggest that TIL has prevented excessive and untimely use of credit by consumers ignorant of its cost? Has disclosure helped consumers choose between credit and use of liquid assets, between credit and delayed consumption?

Credit versus use of liquid assets. In the Brandt-Day sample of consumers who made major purchases, 43 percent used cash. Of the 57% who bought on credit, 28 percent had enough cash to choose between using cash or credit. These data are summarized below:

Cash buyers	43%	
Credit buyers	57%	28% Cash available
		72% Cash not available

If it is assumed that all cash buyers had a choice, it appears that about three-fifths of buyers could choose between cash and credit.

Obviously, the remaining two-fifths did not use the APR to choose between using credit or liquid assets. Buyers who chose to use credit rather than postpone their purchases tended to be less than 45 years old and had young children, incomes below $7,500 and nonmortgage monthly debt payments relatively high in relation to income.

The benefits of rate disclosure for comparing rates received on savings to rates paid for the use of credit accrued principally to more affluent consumers.

Disclosure of rate information seemed to contribute little to those who could choose whether to use cash or credit. The Shay-Schober study noted that prior to TIL, borrowers greatly underestimated finance rates. Yet only 1 to 3 percent of all buyers in the Brandt-Day study reported that they would not continue to buy on credit after becoming aware of the disclosed rate. In a further analysis of the factors affecting the choice between cash and credit, Brandt-Day found that awareness of rates made no contribution to the cash versus credit decision. Of greater importance was the purchase price of the item and the existence of savings.

Credit versus delayed consumption. How many families had a choice between using credit and postponing consumption? The Brandt-Day study indicated 26 percent of families surveyed purchased a durable good to replace an item no longer usable. Another 27 percent bought a particular household durable or car for the first time. Replacement purchases

were characteristic of older families. Younger families more typically were first-time purchasers. Because the urgency of a first-time purchase cannot be determined, it appeared that between a fourth to a half of the families had no choice between using credit and postponing purchase.

Did TIL disclosure influence consumers who could have but did not postpone credit purchases? This is difficult to answer because whether consumers balance the APR or the dollar finance charge—or neither—in deciding to buy now or later is unknown. Available surveys do not include consumers who did postpone purchases. The somewhat greater awareness of the dollar finance charge in comparison with APR awareness in the Brandt-Day study suggests the dollar finance charge may be a more important consideration to consumers, but the evidence is tenuous.

There is no evidence that disclosure of the APR frightened consumers into postponing use of credit as some witnesses predicted as TIL hearings. One experiment found that replacing monthly rates and add-on rates with true APR's did not alter the acceptability of instalment contracts.[54] In his study of disclosure legislation in Massachusetts, Pullen found no evidence that the new form of disclosure had an impact on credit sales.[55] Brandt and Day found some evidence that better awareness of rates and finance charges could result in postponement of purchases in a small proportion of cases.

Whereas previous studies showed consumers frequently underestimated the APR on instalment contracts prior to TIL, the Brandt-Day study indicated they tend to *over*estimate the amount of the dollar finance charge, a phenomenon also observed by Deutscher. It may be that disclosure encouraged use of credit by some consumers who found it less costly in terms of dollars than they believed. Still to be determined is whether consumers who have a choice use the APR, the dollar finance charge, or some other factor, such as the monthly payment, in deciding whether to use credit or postpone purchase. The amount of the dollar finance charge is probably influential in decisions involving small unpaid balances and the APR more important to decisions on large debts, such as mortgage loans.

Another reason disclosure had little or no effect on decisions to buy now or later may be that consumers believe advantages of immediate ownership far outweigh the cost of financing. A paper prepared for the Commission by Professor William C. Dunkelberg of Stanford University found rates of return to consumers from owning an average priced washer-dryer ranging from 12.8 percent for five loads per week to 65.4 percent for eleven loads per week.[56] Although consumers do not calculate internal rates of return, their assessment of the economic advantages of immediate purchase could suggest that postponement of purchase would be economically unsound, even at APR's in the 18 to 36 percent range.

Economic stabilization function

Arguments were made at the Senate TIL hearings that contributions to economic stabilization by disclosure would come from two possible sources. First, disclosure of the finance charge and APR would prevent consumers from accumulating excessive debt leading to a rash of bankruptcies in a recession. Second, disclosure of the APR would be contracyclical in discouraging the use of credit in a boom and encouraging its use in a depression.

It is difficult to see how APR disclosure could have been expected to prevent excessive use of debt. A consumer who is overindebted is one who is unable to meet his monthly payments. As noted earlier, the level of the monthly payment usually depends more on the dollar amount financed and the maturity of contract than on the APR. A short-term contract for a large amount financed at 6 percent might lead a consumer to bankruptcy, but the same consumer might never miss a payment on a long-term contract for a small balance financed at 40 percent. Mere disclosure of the APR does not inform the consumer about his ability to meet monthly payments, although it may cause him to pause long enough to ponder the problem. To budget his obligations, a consumer needs to know the size and timing of periodic payments.

Of all the terms of credit agreements, consumers are probably most aware of the required monthly payment. Because it is in the interest of both creditor and debtor that repayment obligations be clear, this form of awareness predates TIL by many years. The Brandt-Day survey found that almost all buyers knew the maturity, amount financed and monthly payment associated with their credit purchase. Since TIL did not *add* information that could be used by consumers to determine whether they were capable of ultimately making the payments, TIL cannot be faulted for continued consumer bankruptcies. The answer to that problem lies largely in teaching consumers to budget incomes and expenditures.

To some extent the analysis advanced by Tobin[57] in 1961 does not apply to the consumer credit market in 1972. At the time of his testimony, revolving credit was less important than it is in today's consumer credit market. Because rate ceilings on revolving credit have been generally fixed at or below the market rate, there is considerable uniformity of rates, both within each state and over time. So, in a boom period, when it might be desirable to restrict use of credit, consumers continue to use open end credit because they see no increase in their

496-072 O - 73 - 14

costs. The bank or retailer, however, faces increased costs as the supply of money relative to demand begins to decline. As the bank begins to lose money on credit operations, it will probably increase the discount charged retailers for buying instalment paper. Whether responding to rising costs of his own credit operations or the deeper discount on bank credit cards, the retailer will probably increase prices of goods and services. If the price increase forces consumers to postpone purchases, the transfer of a portion of the finance charge on revolving credit into the cash prices of goods and services will help to dampen the boom. Nonetheless, consumers may still decide to buy even at higher prices by using apparently "low cost" revolving credit. Some former cash buyers may opt for credit. Should this occur, revolving credit would certainly not have a contracyclical effect, but would further fuel the boom.

But TIL probably does make some contribution to economic stability by disclosing the fluctuating cost of closed end credit to consumers. The effect is probably minimal on rationed consumers, because they would be willing to use more credit at any rate. Because they concentrate on the availability of credit as reflected in monthly payments required, they are influenced little, if at all, by changes in quoted APR's. In contrast, unrationed consumers–affluent and better educated–are more aware of the APR and can choose to use more or less credit. They are more likely to respond to APR variations, probably more in boom times than in a recession. Even though many consumer credit rates decline cyclically, consumers who face the risk of unemployment are unlikely to assume additional debts just because financing rates are lower. While higher financing rates may dampen a boom, you cannot induce consumers to borrow in a depression period by providing lower finance rates.

Nor does TIL need to carry the full burden of influencing the timing of credit purchases and repayments. Rising costs of money and competing demands for credit also operate on the supply side to reduce the availability of credit in a boom. In an extensive study of consumer instalment credit, the FRB observed the mechanism for control on the supply side:

> This examination of the mechanism of response has indicated that changes in costs and in availability conditions in the credit market, induced jointly by rising credit demands and monetary action directed toward moderating the expansion of credit, impinge to some degree, which cannot be precisely quantified, upon lenders of consumer instalment credit. Instalment lender-borrower relationships in both the bank and nonbank areas are not isolated from general credit market developments. The effects come sooner to some than to others but, given a tightening market condition of substantial duration, each consumer instalment lender is eventually affected. His actual or imputed costs rise; his supply alternatives narrow; and the potential further expansion of credit which he can finance is, in one way or another, limited.[58]

The Commission believes the role of TIL as a tool of economic stabilization would be enhanced if consumers could observe and react to changing credit costs. To facilitate this response, *the Commission recommends that the Board of Governors of the Federal Reserve System regularly publish a statistical series showing an average (and possibly a distribution) of annual percentage rates for at least three major types of closed end consumer instalment credit: new automobiles, mobile homes, and personal loans.* These price indices should be related in some manner to other elements of the credit offer function when the data are reported. The recently published Federal Reserve Statistical Release G. 10 substantially meets the intent of this recommendation.

RECOMMENDATIONS TO INCREASE EFFECTIVENESS OF DISCLOSURE

A number of amendments to Title I (Truth in Lending) of the Consumer Credit Protection Act (CCPA) have been proposed. The Commission thoroughly studied possible changes in the nature of information to be disclosed, the method of disclosure, and other issues.

Nature of information disclosed

More-than-four-instalment rule. The "more-than-four-instalment rule" arose out of the definition of "creditor" in TIL, Section 103 (f):

> The term "creditor" refers only to creditors who regularly extend, or arrange for the extension of credit *for which the payment of a finance charge is required,* whether in connection with loans, sales of property or services, or otherwise (emphasis added).

Section 121 (a) then defines the obligations of creditors:

> Each creditor shall disclose clearly and conspicuously, in accordance with the regulations of the Board, to each person to whom consumer credit is extended *and upon whom a finance charge is or may be imposed* the information required under this chapter (emphasis added).

As the FRB reviewed this language, it appeared that credit sellers might escape regulation by burying the

finance charge in the price of the goods. For example, a credit jeweler levying no explicit finance charge would be permitted to advertise watches at $1 down and $1 per week without indicating the number of payments required or the total time price.

It should be obvious, however, that even if a service is "free" to consumers it is not free to the credit seller. A retailer may make no direct charge to consumers for the use of a parking lot, for delivery of goods, or for the services of an interior decorator. But, if he wishes to attract capital and stay in business, the retailer must earn a return on investment in the parking lot and delivery trucks and must recover direct outlays made to provide these services. To do so he must raise the prices he charges for merchandise. The same reasoning holds for provision of consumer credit. Any retailer offering consumers the opportunity to defer payment must recover additional costs and must earn an adequate return on investment in receivables, computers, and other assets needed to process the receivables. If a retailer levies no overt finance charge, these expenses and required returns must be included in the "cash" price of the goods and services sold. Thus, the FRB reasoned that a finance charge must be present, even though not specifically identified. This led to the definition of "consumer credit" in Section 226.2 (k) of regulation Z as

> . . . credit offered or extended to a natural person, in which the money, property, or service which is the subject of the transaction is primarily for personal, family, household, or agricultural purposes and for which either a finance charge is or may be imposed *or which,* pursuant to an agreement, *is or may be payable in more than 4 instalments* (emphasis added).

Since the U.S. Fifth Circuit Court of Appeals has held the rule to be invalid in *Mourning* v. *Family Publications Service, Inc.*,[59] the Commission supports the FRB recommendation that TIL be amended to make clear that TIL applies to consumer credit transactions payable by agreement in more than four instalments irrespective of a finance charge. *The Commission recommends that the Truth in Lending Act should be further amended to require creditors who do not separately identify the finance charge on credit transactions involving more than four instalments to state clearly and conspicuously in any advertisement offering credit: "THE COST OF CREDIT IS INCLUDED IN THE PRICE QUOTED FOR THE GOODS AND SERVICES."*

Real estate credit. The same reasoning that led the FRB to argue that the selling price of goods sold on credit must include the finance charge if not explicitly stated also leads the Commission to conclude that points paid on real estate transactions must also be part of the finance charge, whether paid by buyer or seller. Contrary to the regulation Z interpretation (Section 226.406), *the Commission recommends that the Truth in Lending Act be amended to make clear the presumption that all discounts or points, even when paid by the seller, are passed on to the buyer and hence must be included in the finance charge.*

Points paid by the seller are not inconsequential. According to a recent study of settlement costs in six metropolitan areas in March 1971, "the average HUD insured Section 203(b) mortgage in these areas required an average of nearly three points in loan discount payments paid by the seller and an additional one point (origination fee) paid by the buyer."[60] On houses in the $20,000 to $28,000 price range these fees averaged $598 paid by seller and $228 paid by buyer. When a seller pays nearly $600, he must increase the selling price of his house to cover the points, or be willing to reduce the selling price in lieu of paying the fee to the lender.

Another problem associated with real estate credit is illustrated by the Statement of Purchase shown in Exhibit 10-4. Part of the problem arises from inconsistent definitions of the finance charge in TIL. The basic definition of the finance charge is set forth in Section 106(a):

> Except as otherwise provided in this section, the amount of the finance charge in connection with any consumer credit transaction shall be determined as the sum of all charges, payable directly or indirectly by the person to whom the credit is extended, and imposed directly or indirectly by the creditor as an incident to the extension of credit, including any of the following types of charges which are applicable:
>
> (1) Interest, time price differential, and any amount payable under a point, discount, or other system of additional charges.
> (2) service or carrying charge.
> (3) Loan fee, finder's fee, or similar charge.
> (4) Fee for an investigation or credit report.
> (5) Premium or other charge for any guarantee or insurance protecting the creditor against the obligor's default or other credit loss.

However, Section 106(e) *excludes* from the finance charge the following items "when charged in connection with any extension of credit secured by an interest in real property."

> (1) Fees or premiums for title examination, title insurance, or similar purposes.
> (2) Fees for preparation of a deed, settlement statement, or other documents.

EXHIBIT 10-4

STATEMENT OF PURCHASE

File No. .... Dated June 11, 1970

Prop.
Desc. Lot 5, Section 4, PINE RIDGE

CHARGES TO PURCHASER:

Purchase Price		$ 44,000.00
Hazard Insurance		$ 77.00
Hazard Insurance		$
Prepaid Taxes, 19, 70, 6 Month(s) in Escrow		$ 372.60
Hazard Insurance Prepaid, Month(s) in Escrow		$
F.H.A. Insurance. Month(s) in Escrow		$
Loan Fee		$ 330.00
Interest on New Loan to		$
Loan (House Location) Survey		$ 60.00
Assumption Fee	$82.50 Lawyers Title	$
Loan Title Insurance Application and Premium	$25.00 HDSH	$ 107.50
.... Closing Charge		$ 20.00
.... Notary Fee		$ 1.00
Rent Adjustment		$
Town—City Taxes		$
County Taxes 6/11/70 - 6/30/70		$ 42.12
Escrow Funds with Loan Company Due Seller		$
Credit Report		$ 8.00
Appraisal Fee and/or Inspection Fee—Lender		$ 30.00
TOTAL Amount Due		$ 45,048.22

CREDITS TO PURCHASER:

Amount Paid Down	$ 500.00	
First Trust	$ 33,000.00	
Interest From ...... To	$	
Second Trust	$	
Interest From ...... To	$	
Prepaid Charges	$ 38.00	
Town—City Taxes (Adjusted) 19	$	
County Taxes (Adjusted) 19	$	
Rents (Prorated)	$	
TOTAL CREDITS		$ 33,538.00
Balance Due		$ 11,510.22

EXPENSES:

Preparing Deed		$	
Preparing Deed of Trust(s) and Note(s)		$	
Recording Deed: State & County Tax	$88.00		
Transfer Fee	$ 1.00		
Clerk of Court	$ 5.00	$ 94.00	
Recording Trust: (1st): State & County Tax	$66.00		
Clerk of Court	$10.00	$ 76.00	
Recording Trust: (2nd): State & County Tax	$		
Clerk of Court	$	$	
		$	
Examination of Title		$ 440.00	
Closing & Processing Fee		$ 35.00	
Loan Transfer Fee		$	
Certificate of Title—Purchaser		$	
Professional Services.		$ 100.00	
Professional Services.		$ 100.00	
		$	
Owner Title Insurance Application and Premium		$	
Notary Public.		$	
Sewer Assessment		$	
Water Assessment		$	
TOTAL			$ 845.00
BALANCE DUE FROM PURCHASER			$ 12,355.22

The undersigned hereby certifies that prior to settlement the cash payment shown as "Amount Paid Down" above was made and this settlement is approved as being in accordance with the terms of the contract with the Seller, and a copy of this statement was received.

(3) Escrows for future payments of taxes and insurance.
(4) Fees for notarizing deeds and other documents.
(5) Appraisal fees.
(6) Credit reports.

The Commission believes that a fundamental principle of disclosure should be equal treatment of all creditors. Otherwise, unequal competition is fostered, and consumers cannot effectively shop for credit. Referring to Exhibit 10-4, it may be observed that if this were *not* real estate credit, the creditor would have to include in his finance charge at least the following items:

Loan survey	$ 60.00
Loan title insurance application	25.00
Credit report	8.00
Appraisal fee and/or inspection fee	30.00
Closing and processing fee	35.00
Added finance charge	$158.00

These charges are made as an incident to the extension of credit for paper work and credit investigation. A credit union, consumer finance company, or bank would be required to include these costs in the fiannce charge if, for example, it were extending an automobile loan. The Commission cannot justify excluding such extra fees from the finance charge in real estate credit. To avoid this uneven treatment of finance charges, *the Commission recommends that Section 106(e) of the Truth in Lending Act be amended to delete as excludable from the finance charge the following items numbered in accordance with that paragraph:*

(5) Appraisal fees.

(6) Credit reports.

In the example, an increase of $158 in the aggregate finance charge would, of course, have a *deminimus* effect on the disclosed APR. However, for smaller loans of shorter maturity, the effect of a $158 increase in the finance charge would be material. It is already clear under existing law and regulations that any fee for the preparation of a truth in lending statement should be included as part of the finance charge.

Problems still remain with real estate credit. Without commenting on the level or validity of the charges, the Commission calls attention to other fees excluded from the finance charge:

Title insurance	$ 82.50
Examination of title	440.00
Professional services	200.00
Total	$722.50

When these fees and charges are presented at final closing, it is too late for a consumer to withdraw from the transaction without risking loss of downpayment and other prepaid outlays. *The Commission recommends that a full statement of all closing costs to be incurred be presented to a consumer prior to his making any downpayment. In any case, a full statement of closing costs should be provided at the time the lender offers a commitment on a consumer credit real property transaction or not later than a reasonable time prior to final closing.*

Public utility exemption. Under Section 104(4), TIL exempts from disclosure "transactions under public utility tariffs, if the FRB determines that a state regulatory body regulates the charges for the public utility services involved, the charges for delayed payment, and any discount allowed for early payment." In a meeting February 23, 1972, the Commission discussed removal of the utilities exemption and now *recommends the repeal of Section 104(4) of the Truth in Lending Act which exempts public utility transactions from disclosure requirements.* In most cases removal of the exemption would not require disclosure of an APR because of the small dollar amount of finance charge involved. Only if the finance charge exceeds $5 where the amount financed is $75 or less, or is greater than $7.50 for an amount financed exceeding $75, would the public utility have to calculate and disclose an APR. But other disclosure requirements would be applicable, especially the provision that consumers be shown the dollar amount of the finance charge.

Premiums for credit life and accident and health insurance. Insofar as the truth in lending aspect of credit insurance is concerned, *the Commission recommends that creditors be required to disclose the charge for credit insurance both in dollars and as an annual percentage rate in the same manner as the finance charge is required to be disclosed. Additionally, where credit insurance is advertised, the Commission recommends that the premium be required to be expressed as an annual percentage rate.*

Agricultural credit. Previous recommendations have related to more accurate definitions of the finance charge and fuller disclosure of finance charges on public utility bills, but in one area the Commission believes less disclosure is required. Since its first report to Congress in early 1970, the FRB has recommended that credit primarily for agricultural purposes in excess of an appropriate amount should be exempt from the provisions of TIL, irrespective of any security interest in real property. Such a change would retain the benefits of disclosure for small farmers but eliminate possible hindrances to transactions involving more sophisticated borrowers. *The Commission recommends that exempted*

transactions (Section 104) of the Truth in Lending Act should include credit transactions primarily for agricultural purposes in which the total amount to be financed exceeds $25,000, irrespective of any security interest in real property. This is the figure established by Congress in Section 104(3) for exemption from TIL requirements of credit transactions, other than real property transactions.

Methods of disclosure

Concerns have been expressed that the relatively low level of APR awareness stems from methods used to disclose credit terms. The Commission believes that improvement in awareness over the first 15 months after the effective date of TIL disclosure suggests a need for greater patience rather than significant tinkering with TIL provisions.

Advertising. One intention of disclosure legislation was to reduce advertising of consumer credit rates in a variety of forms—discount, add-on, percent per month, and so on—that tended to confuse or mislead consumers.[61] With some exceptions, this misleading rate advertising has disappeared. In addition, advertisements trumpeting $1 down and $1 per week have been virtually eliminated. Such results must be counted as a major accomplishment of TIL.

Still, some supporters of disclosure have been disappointed that there has been little or no rate advertising. They fear disclosure comes too late to permit comparative shopping. Pullen reported that the reaction of bankers ranged from relief to delight with the disappearance of rate advertising, because "the elimination of rate advertising had removed a potentially important source of downward pressure on fiannce charges."[62] Although still infrequent, rate advertising seem to be increasing. In testimony before the House Subcommittee on Consumer Affairs in 1972, Governor J. L. Robertson, Vice Chairman of the Board of Governors of the Federal Reserve System, said there were "indications of increased use of more specific advertising." For example, the March 31, 1972 issue of *Bankers Research* comments that automobile dealers "can't keep their salesmen steamed up about signing up the financing in the face of widespread and incessant advertising of 9%, 8% APR rates (in a few instances even less) by banks."

Some have argued that TIL should be changed "to require lenders who advertise to disclose in their advertisements the rates at which they make various loans."[63] The Commission does not agree. Other suppliers of consumer goods and services are permitted to advertise whatever aspects of a purchase transaction they believe most important or attractive to consumers. Sometimes they advertise price, sometimes not. Firms offering credit to consumers should have the same options. The Commission is as opposed to requiring rate advertising as to prohibiting it which the 1927 Moneylenders Act did in England. In this connection, the Crowther Commission recommended that "a lender who advertises the availability of non-purchase-money-loans should be *allowed* to state in an advertisement the effective rate or rates of charge . . ." (emphasis added)[64]

The Commission does not advocate the required posting of rates at entrance to establishments offering credit. Such posters could readily be used as deceptive "bait" advertising. For many credit grantors such as retailers, the complexities and variety of terms offered would so confuse consumers that they might ignore the posted rates. If consumers are not interested in the APR, especially on small transactions, as indicated by the Brandt-Day study, government should not force rate advertising on them.

There are aspects of credit advertising which the Commission believes can be simplified to encourage advertising of credit terms. First, *the Commission recommends that creditors offering open end credit be permitted to advertise only the periodic rate and the annual percentage rate.* This would be consistent with the requirement now applicable to advertising of closed end credit. Second, *the Commission recommends that where terms other than rates are advertised, only the following terms must be stated in the advertisement:*

Closed end credit	*Open end credit*
The cash price or the amount of the loan as applicable	
The number, amount, and due dates or period of payments scheduled to repay the indebtedness if the credit is extended	*The minimum periodic payment required and the method of determining any larger required periodic payment*
The annual percentage rate, or the dollar finance charge when the APR is not required on small transactions.	*The method of determining the balance upon which a finance charge may be imposed*
	The periodic rate(s)
	The annual percentage rate(s)

Third, *the Commission recommends that Sections 143 and 144 of the Truth in Lending Act be amended to make clear that there may be no expression of a rate in an advertisement of closed end credit other than the annual percentage rate as defined in the Truth in Lending Act and regulation Z.* The Commission is concerned that advertisements displaying rates other than the APR persisted for months and sometimes years after the effective date of TIL.

There are no civil penalties for failure to comply with TIL advertising requirements. Failure to comply with these requirements itself constitute false and misleading advertising and the Commission believes that the FTC and other agencies have adequate authority to stop such violations. However, Congress should grant these agencies authority to impose an appropriate civil penalty for false and misleading advertising. If an agency fails to enforce compliance with TIL advertising provisions, its responsibility should be transferred to a more energetic agency.

The Commission does not believe that false or misleading advertising should be subject to private class action damage suits because of the difficulties in producing convincing evidence of the extent of damage suffered by consumers. To permit such class action damage suits might generate more mischief than benefits—and ultimately higher prices for consumers. *The Commission recommends the adoption of legislation to permit private suits seeking injunctive relief for false or misleading advertising.*

Oral disclosures. There is considerable evidence that oral disclosure of credit charges are often not made in terms of APR:

> There is a very strong indication from the comments that it is common practice for the lender to quote the add-on, as opposed to the annual rate, when asked what rates he gives. When it comes time to sign the agreement the lender enters the annual percentage rate on the contract or loan agreement in full accord with the law.[65]

A small and limited survey of the Detroit area in early 1972 found only one of 20 auto dealers quoted the APR for financing a new car; four gave both the add-on rate and APR; the remaining 15, only the add-on rate. Three of six banks called gave only the discount or add-on rate. One bank refused to quote rate information, and two gave the correct APR.[66]

The Commission recommends that the Truth in Lending Act be amended to provide that the Act and regulation Z apply to oral disclosures. Whether in a credit agreement or in response to an oral inquiry, the only form of time-rate quotation permitted should be the APR.

Timing of disclosure. One survey of new car buyers showed that 40 percent of the respondents received disclosure "less than 10 minutes before signing the agreement with an additional 27 percent gaining disclosure only an hour before signing." The authors of this study suggest that it would "seem reasonable to require at least an hour differential between disclosure and signing."[67] In this instance, the Commission believes it preferable to let the decision rest with the consumer. If he wishes to ponder a credit transaction for an hour, a day, or a week, he can do so under the present system. But if he wants to sign a contract within 10 minutes of receiving disclosure information, that should also be his right.

Inconsistent State requirements. Some state statutes require disclosures by some credit grantors sufficiently different from the Federal statute that the credit grantors feel obliged to provide two different disclosure statements, one complying with the state statute, the other with the Federal statute. This defeats the purpose of TIL, because it confuses consumers. *The Commission recommends Federal preemption of state laws which are inconsistent with the Federal Truth in Lending Act or which require disclosures which might tend to confuse the consumer or contradict, obscure, or detract attention from disclosures required by the Truth in Lending Act and regulation Z.*

Other issues

Right of rescission. Section 125 of TIL provides that in certain credit transactions in which a security interest in the consumer's residence is created, the consumer has three business days in which to rescind the transaction. The rule does not apply in the cases of a first lien to finance the construction or acquisition of a consumer's residence or advances for agricultural purposes under an open end real estate mortgage.

At dispute is whether this right of rescission applies to nonconsensual liens, such as mechanics' liens. The Commission believes a "cooling-off" period should be accorded to any consumer when a security interest is or may be acquired by a creditor in his home, risking its loss by foreclosure. *The Commission supports the recommendation of the Board of Governors of the Federal Reserve System that Congress amend the Truth in Lending Act specifically to include under Section 125 security interests that arise by operation of law.*

The FRB pointed out in two previous reports that the rescission period runs indefinitely unless required disclosures have been made and notice of rescission provided.

This clouds the titles to many residential properties and injures consumers in the long run. *The Commission supports the recommendation of the Board of Governors of the Federal Reserve System that Congress amend the Truth in Lending Act to limit the time the right of rescission may run where the creditor has failed to give proper disclosures.* The period recommended by the FRB (three years, or until the property is sold, whichever is shorter) appears reasonable.

Liability of assignees. The Commission considers whether a financing agency which buys consumer paper should be held equally liable with the original creditor for noncompliance with TIL when noncompliance is evident on the face of the disclosure statement. Such a requirement would tend to add another level of enforcement, because the bank or finance company would have an incentive to require compliance with TIL by dealers supplying instalment paper. Some argue that added costs of checking the paper imposed on the assignee would result in less availability of credit for dealers and higher finance charges to consumers. Because careful checking by the assignee should permit reduced governmental expenditures on enforcement, there is no reason to believe that total administrative costs (ultimately borne by consumers in either case) would necessarily be greater if the assignee were held responsible for compliance.

Reports that administrative agencies interpret TIL unevenly, that some finance companies have been unable or unwilling to buy consumer instalment paper because of FTC directions, and that commercial banks subsequently bought the questionable paper disturbed the Commission.

To resolve these problems, *the Commission recommends, first, that the Truth in Lending Act be amended as necessary to assure that subsequent assignees are held equally liable with the original creditor when violations of the Truth in Lending Act are evident on the face of the credit agreement or disclosure statement.* Because assignees frequently provide nonconforming forms to their dealers, responsibility for violations may rest with them more than with their dealers. Presumably, assignees also check instalment agreements for compliance with various state laws. It should not be a great burden for them to make random verifications for TIL compliance. Surely, an assignee is (or should be) more aware of which of his dealers *need* close surveillance than an examiner from some supervisory agency. Second, *the Commission recommends that there be equal enforcement by all appropriate agencies of this, and all other, Truth in Lending Act provisions to assure equal protection to all consumers.*

Tax deductibility of finance charges. An earlier draft of the Commission report deplored the discriminatory ruling of the Internal Revenue Service (IRS) that permitted finance charges on bank credit cards to be treated as interest and tax deductible, while denying similar treatment of finance charges on merchant revolving credit accounts (Revenue Ruling 71-98). Whether or not the early draft helped to reverse the ruling, the Commission commends the IRS for its recent Revised Ruling 72-315, permitting retail store customers using revolving charge accounts to deduct finance charges as interest on income tax returns.

Class action suits. The Commission supports that part of Governor Robertson's statement before the House Subcommittee on Consumer Affairs about class actions. He said that "almost unlimited class action exposure may be detrimental to consumer interests and, in fact, may be an impediment to effective private enforcement of Truth in Lending through class action." Despite minimal probability of success, the expected value of a class action against a giant corporation could be considerably higher than one against a virtually judgment proof small, avaricious credit grantor. The record suggests that attorneys are capable of comparing these expected values. The FRB has furnished to the Senate Subcommittee on Financial Institutions the following wording for insertion in the civil liability section of the Truth in Lending Act (Section 103(d)).

> "No provision of this section imposing any liability shall apply to any act done or omitted in good faith in conformity with any rule, regulation or interpretation thereof by the Board, notwithstanding that such rule, regulation or interpretation may, after such act or omission, be amended or rescinded or be determined by judicial or other authority to be invalid for any reason."

The FRB also suggested clarification of "transactions" in Section 125(f) of the Truth in Lending Act:

> "The multiple failure to disclose to any person any information required under this chapter to be disclosed in connection with a single account under an open end consumer credit plan, other single consumer credit sale, consumer loan or other extension of consumer credit, shall entitle the person to a single recovery under this section."

As a step toward providing more meaningful consumer protection *the Commission recommends adoption of both suggestions of the Board of Governors of the Federal Reserve System pertaining to class action suits and the clarification of the definition of "transactions."*

SUMMARY

Full disclosure of terms on consumer credit transactions was the subject of long and vigorous debate in the United States and abroad. After eight years of controversy, the disclosure statute managed by Senator Proxmire in the Senate and Congresswoman Sullivan in the House became law in May 1968.

The statute was intended to enable consumers to comparison shop for credit, to choose between using credit or liquid assets and between credit and delayed consumption, and to assist in economic stabilization. It was not intended to remedy all abuses in the credit market or to fix rates of charge on consumer credit transactions.

Evidence suggests that awareness of the APR increased significantly in the 15 months following the effective date of TIL. Still, substantial proportions of consumers remain unaware of the APR's they were charged, particularly consumers with high school education, or less with family incomes below $8,000, who were more likely black than white, and who rented residences in poverty areas. Interrelation between the finance charge and the cash price of goods purchased diminishes the impact of APR disclosure in sales credit. Pre-existing institutional knowledge of relative costs of credit from different sources reinforces the shopping function fostered by disclosure of APR's and is, in turn, strengthened by such disclosure.

Disclosure has probably been less effective in achieving its descriptive and economic stabilization functions, probably the least important objectives. Many problems lie less with TIL than with inherent characteristics of the marketplace. As shown earlier, disclosure was of little value to the 41% of credit buyers in the Brandt-Day study who had no cash available. In general, the Commission's conclusions complement those of Governor Robertson: "The public is better informed than before enactment of Truth in Lending, the major problems in implementation have been solved, and with continued education the benefits to the public will increase."[68]

The Commission made no effort to undertake a cost-benefit analysis. Benefits of TIL now appear to accrue largely to consumers in the more affluent general market, but no available data show the total costs borne by the government and industry or how these costs have been distributed among consumers.

Stemming from the principle that consumers should receive properly comparable disclosures and equal treatment, regardless of the source of their credit, the Commission made a number of recommendations to Congress for amendments to the Truth in Lending Act. Some of these recommendations are already on their way to enactment for which the Commission commends the Congress.

Chapter 11

EDUCATION

The Commission's mandate from Congress to "study and appraise the functioning and structure of the consumer finance industry, as well as consumer credit transactions generally" could not be carried out fully without an appraisal of what consumers themselves know—and should know—about economic processes which involve them directly. Legislation designed to foster competitive finance markets will be ineffective if consumers are not knowledgeable enough about operations of those markets to be able to obtain fair and full benefits from them. Protections afforded by such legislation as the Consumer Credit Protection Act (CCPA) and the Fair Credit Reporting Act are weakened if consumers do not understand their rights and obligations under the law. How well informed are consumers about the uses and abuses of credit? And if their education is lacking, what and how should they be taught—and by whom?

Consumers' Need to Know

A properly functioning credit system will maximize the benefits that obtain from the use of credit relative to the price of the credit.[1] This so-called consumers' surplus is enhanced when consumers have the marketplace information they need to make wise shopping decisions and when they know how to use it effectively.

The Truth in Lending law (TIL) was designed to provide consumers with the information necessary for them to make intelligent choices in credit markets. That may not be enough. As noted in Chapter 10, an apparent awareness by buyers of credit rates charged does not necessarily mean that they make intelligent decisions. There are no universal standards judging the sensible use of credit by an individual any more than there are such criteria for determining whether he makes the right decision in buying an automobile, bedroom suite or washing machine he thinks he wants.

But if consumers are armed with the facts and figures available under TIL requirements, if they are properly schooled in their use, know how to translate them into personal terms, they should be able to increase their surplus from credit services, even if precise measurement is not possible.

Education should not only help consumers know how to obtain credit at reasonable rates but should enable them to judge how much credit they can manage without defaulting.

In some defaults the consumer may have concealed other debts from the creditor grantor or may have refused to pay even though able to do so or may have no justifiable complaint about the credit arrangement.

But in most default cases the consumer simply misjudged ability to manage credit obligations. Perhaps he failed to allow enough slack to absorb short-term fluctuations in income. Maybe he did no budgeting at all, or had only a dim idea of fixed monthly commitments. He may not have figured the cumulative load of instalment contracts for a half-dozen household durables, each chosen carefully, each financed reasonably—but together bringing disaster.

In any event, effective education should result in fewer defaults—and make the credit market better for creditors as well as consumers.

Education should not only improve the effectiveness of existing consumer legislation but lessen the need for it as well. It should help keep consumers out of situations that lead them into the courts. If they learn not to sign contracts in blank, there will be no need for legislation prohibiting the practice or for enforcing what is already law. If they learn to be wary in credit purchases there will be less need for detailed protective legislation dealing with such things as contract warranties, the holder in due course doctrine and precommitment cooling-off periods.

When consumers are aware of their legal rights, credit grantors will be less able to take unfair advantage of them. Knowledge of the law is often more effective in protecting the consumer than strict enforcement by supervisory agencies.

Education in the use of consumer credit can be preventive or remedial. Preventive education, preparing consumers for ventures in the marketplace, obviously is to be preferred to remedial education, pointing out to consumers what they should have done.

Schooling in the benefits, intricacies, pitfalls and perils of credit financing is but part of the overall educational process consumers need. Finance charges

they pay are dwarfed by their expenditures on other services and goods. During 1970, finance charges paid amounted to \$16.9 billion compared with \$615.8 billion in other personal consumption expenditures.[2] While buyers can make unwise credit decisions, their margin for error is much greater in the good or service purchase decision. The consumer who needs to know more about the financing of purchases needs to know much more about the economics of life in general. The place to begin to learn is at home or in school rather than in the trial-and-error arena of the marketplace.

School Programs

Consumer education, started in U.S. public schools around the turn of the century as part of home economics curricula, has long since been broadened to encompass more than kitchen lab practice. But it still has a secondary place in most school systems.

The American Home Economics Association was an early advocate of broader classroom training and by 1915 more than 25 percent of secondary schools had incorporated household budgeting and market selection in their curricula. The Federal Government encouraged this trend by specifying the inclusion of "business management of the home" in the home economics curriculum under the Vocational Education Act of 1917.[3]

Development of consumer education in the schools was erratic from 1920 until 1950 during changing economic and social conditions in the country. General interest in consumer education seemed to wane in the 50's until the Council on Consumer Information (now the American Council on Consumer Interests) was established in 1958 and the National Committee for Education in Family Finance began sponsoring summer workshops for consumer education teachers.

Renewed Federal and state interest in consumer education came in the 1960's. In 1968, amendments to the Vocational Education Act[4] made Federal funds available specifically for consumer education courses and earmarked a third of them for use in economically distressed areas. A 1970 survey report prepared for the Department of Health, Education, and Welfare[5] noted that "there was an awakening to the plight of the individual in a technological society and great concern with the quality of life in the United States," and that "widespread rural to urban migration and drastic changes in family life style" were also stimulants.

A noteworthy development occurred in 1967 when the Illinois Legislature adopted a bill providing that public school pupils in grades 8 through 12 "shall be taught and required to study courses which include instruction in the area of consumer education, including but not necessarily limited to instalment purchasing, budgeting, and comparison of prices." The Superintendent of Public Instruction was authorized to devise or approve the curriculum. Each school has been allowed to determine how best to implement the 1967 mandate. Since then Hawaii also has required consumer instruction in high schools. Other states have encouraged development of elective courses and provided curriculum guides.

Effectiveness of high school instruction would be increased if preceded in elementary school by courses designed to give children an understanding of the American economic system. Adequate course materials are available.[6] Studies have shown that even fourth-graders can absorb basic economic concepts when they have skilled teachers and proper instructional aids.[7]

For 70 years educators have debated issues concerning consumer education—when and where it should start in the public schools, what emphasis it should have, whether it should be mandatory, what should be taught. There is no general agreement on all the specifics. But there is little disagreement on the proposition that before they leave their last classroom all students should have some useful training in how to get the most out of a dollar.

High school graduates who go on to college may be further exposed to consumer education. In particular, noncollege bound and nongraduating students who are counseled into vocational training need consumer education, because they will encounter marketplace problems early and for the rest of their lives. Yet many never take a home economics course or other courses which could help them.[8]

The Curriculum

A recent survey shows that consumer education is most generally offered in public schools as part of the home economics, business, or social studies curricula.[9] Some instruction may be mixed into mathematics, industrial arts, health, science, drivers' education and even English courses. Special comprehensive courses for consumer education have been developed, usually in the home economics curriculum. But for the most part consumer education is regarded as a supplementary teaching objective.

Dispersal of consumer education through the curriculum has the virtue of making courses in which it is offered more relevant to everyday out-of-school life. But in the diffusion students may not get adequate and uniform exposure to dollar-and-cents basics. Common topics include "consumer in the markets," "family

income management," "consumer in the economy," but other important concepts may be skipped altogether.

Instruction leading to the informed use of consumer credit often is missing. One survey indicates that consumer credit as a subject is treated in no more than 54 percent of upper level consumer courses.[10] Secondary schools also appear to give insufficient attention to consumer legal protection in marketplace transactions and alternatively to legal obligations in credit contracts. For many students, school offers the last good chance to learn about such things. It is clear from Commission studies that failure of the school to teach consumer education leaves many adults without knowledge of their obligations when they sign contracts. *The Commission recommends expanded treatment of consumer credit at both the junior and senior high school levels.*

In 1971, the North Carolina General Assembly conferred adulthood on 18-year-olds, making them fully responsible for their commercial transactions. The North Carolina Bar Association is now offering high schools a law-oriented consumer education program with instructors drawn from the organization's Young Lawyers Section. Working with the Consumer Protection Division of the Attorney General's office, an attorney-teacher covers legal aspects of such topics as consumer credit and protection, banking, insurance, "swindles and gyps" and housing. Charlotte Attorney Ralph C. Clontz, Jr., who chaired the committee which devised the project, says it apparently is the first of its kind to be sponsored by a bar association anywhere. Such specialized instruction is rarer than it should be.

An obvious alternative to disseminating consumer education throughout the high school curricula would be to concentrate it in a single comprehensive course, elective or required, offered during the junior or senior year. Students who skip the course, if optional, would miss that part of their education entirely, but compulsory classes with captive audiences often produce disinterested students.

It may be preferable to delegate basic consumer education to curriculum areas of home economics, business, and social studies because one or another of those subjects is taken by a large proportion of students. Many more students could be reached through these courses than through a single course whose immediate value may not be apparent to them. Curriculum coordination would be required to avoid unnecessary duplication of subject matter. The program could be further strengthened by offering an elective upper division course designed to integrate materials presented in lower division units and to probe problems in greater depth.

Teachers and Textbooks

If there are few universally accepted curriculum standards in consumer education, there are even fewer standards for the training of teachers and the selection and presentation of classroom materials. The Commission does not presume to have answers to all the questions raised inside and outside the academic community about methodology, but some observations can be drawn from the experience of educators in the field and from pertinent studies.

The questions are many. What is the correct approach to the area of consumer credit? Should teachers just review the pros and cons of using credit? Or should the teacher present students with a value system for installment buying? Should students be warned about excessive use of credit? Must they accept a set of values which the teacher has personally adopted?

The teacher may disapprove of paying 18 percent to buy a color television set on time or signing up for 36 payments on a fancier car than needed. But those are personal standards. They may not be suitable for varying life styles of families represented by the students. As Helen Hall has observed, "perhaps those of us who feel we spend more wisely should pause a moment and consider what magnificent adventure one of those ill-considered purchases may mean in the life of a family which has always had to face the dreary business of being poor."[11]

Students should be taught how to establish good credit ratings, how to use credit prudently, how to budget payments within income constraints. As young adults they should be encouraged to develop goals and values to suit their individual needs.

The teacher needs assistance in selecting course materials from a massive and bewildering array of commercial and governmental pamphlets as well as textbooks and other teaching materials. Some are slanted one way or another, others are superficial or not tailored to the maturity of the students they are supposed to interest. They need sorting out. The teacher may find that texts chosen do not deal with economic and social realities faced by those students who need instruction most.

A study of money concepts of Akron eighth grade home economics students from lower and middle class families revealed significant differences in items purchased and in use of credit at different socioeconomic levels.[12] Another study disclosed a direct relationship between student scores in a credit information test and the father's type of occupation.[13] Yet many, if not most, of the textbooks, pamphlets, and other teaching aids offered for consumer education seem to be aimed at

the "Middle America" student. While the student from a comfortably fixed family may find them useful, the low income child may find them meaningless.

There is some advisory help for the teacher hunting for material relevant to individual pupils. Consumer-oriented or educational agencies such as the American Council on Consumer Interests provide preliminary evaluations. Guides and suggested curricula are offered by the Joint Council on Economic Education, American Home Economics Association and National Committee for Education in Family Finance and others. The Office of Education is funding a project to evaluate material written by 100 specialists and production of nine manuals geared for preschool through post-graduate college level programs.

Regardless of how or by whom consumer education aids are screened the payoff for students comes in the classroom where a competent teacher decides which techniques and materials are best suited to help particular students—and particularly those from low income families.

Reporting on a program at Cooley Vocational School in the slums of Chicago, the *Washington Post* cited one example of what can be done by a teacher using little in the way of formal texts and much classroom innovation:[14]

> Dorothy Johnson, short on funds but rich in imagination, has employed a potpourri of teaching aids ranging from play money to government tax forms.
>
> She has dispensed with textbooks and relies almost entirely on free government pamphlets. . . .
>
> In a typical class they might discuss menus and debate whether it's cheaper to order a la carte or from the dinner selection. They might "play bank" and go through the motions of making a deposit, even checking to see if they've been short-changed. . . .
>
> In a recent class. . .the talk revolved about shoddy merchandise; how to recognize it, avoid it and return it. Miss Johnson relied on role playing to show her pupils how to resist the wiles of door-to-door salesmen.

Undereducated Teachers

As with consumer education curriculum and textbooks, there is a lack of generally accepted standards in the academic qualifications of teachers in the field.[15] A domestic science teacher, certified as competent to run a homemaking course, and presumed to be versed in all the economics of consumption, may well be lost in the intricacies of instalment buying.

In 36 states there is no requirement that social studies teachers be trained in economics, although they are the most likely candidates to teach consumer education classes. In fact, only half of such teachers have ever taken a course in economics.[16] A Center for Economic Education Survey of 258 business education programs found that only in 21 programs was economics required in the academic background of prospective business teachers.[17]

Even if prospective high school teachers do study economics in college, they may learn little to prepare them to teach students what they should know about credit purchasing. Basic economic courses deal with larger economic issues and give only slight treatment to consumer finance issues.

Some innovative efforts have been made to fill gaps in the academic backgrounds of consumer educators. For example, the Joint Council on Economic Education and American Council on Consumer Education have undertaken ambitious programs—providing consumer workshops for teachers, developing professional journals, and creating scholarships. The American Home Economics Association has produced teaching tapes in which a lawyer discusses credit laws, a sociologist examines the bankrupt debtor and economists dissect the credit market. The need for better trained teachers remains.

Federal and Private Aid

Innovations in consumer education should be fostered in the schools by the Federal Government and private industry to raise the level of economic literacy of the nation's citizens.

The Commission recommends that Congress support the development of improved curricula to prepare consumers for participation in the marketplace, with adequate attention to consumer credit as one aspect of family budgeting.

Federal financial assistance is needed to initiate consumer education programs at elementary, secondary, and higher school levels, with specific allocations to specialized courses and carefully monitored pilot projects. As a general rule, emphasis should be on research and development—innovation and evaluation of results—rather than on subsidization of ongoing programs.

The Office of Education should provide direct support for workshops and other programs at universities which demonstrate interest and competence in economic education for consumers. These programs might be strengthened if participating students were given some practical experience with consumer protection agencies. The Office of Education could undertake research—in such areas as the psychology of credit users and the

impact of credit education on actual behavior—to develop data for better programs and teaching.

Business, too, should share in financial support of consumer education. Purely as a matter of self-interest, as well as public responsibility, honest businessmen have a stake in it. Uneducated and misinformed consumers are easy targets for unethical and fly-by-night operators who divert income from legitimate firms.

Support from industry already is offered in such undertakings as a special unit on consumer credit developed by the National Foundation for Consumer Credit, an educational series prepared by the Chicago 4-H Association in cooperation with the Sears, Roebuck Foundation, and the Consumer Education Pilot Program of the J. C. Penney Company. But more business help is needed to give honest and meaningful market information to the nation's schoolchildren.

Adult Education

Studies prepared for the Commission disclose that many adult consumers lack knowledge and skills to shop effectively for credit, despite information provided by TIL. For these consumers, high school courses are no help. Other information channels—community classes and workshops, mass media, direct mail—should be opened to them. No figure on the number of adults now participating in consumer education programs is available, but the potential audience has been estimated as close to 25 million.[18]

The target audience of most existing programs consists of young and middle-aged consumers. Few are designed for elderly persons who must live on set incomes and whose purchasing power declines steadily. With rare exceptions, only governmental agencies rank as prime program targets those with family incomes of less than $5,000. Other organizations involved focus on families with incomes between $5,000 and $15,000,[19] figuring that consumers need that much money to have spending choices which can be guided by education.

The Commission recommends that appropriate Federal and state agencies should continue their emphasis on adult education for low income consumers, should try to reach more of them, and should develop useful programs for the elderly.

An adult program of special interest to the Commission involves credit assistance and counseling for low and moderate income home purchases under Sections 235 and 237 of the Federal Housing Act of 1968. A handbook prepared by the Department of Housing and Urban Development outlines responsibilities of local organizations selected to participate:

> The groups will provide continuous budget, debt management, and related family counseling... An important part of counseling will involve discussions with the family of the importance of keeping instalment purchases within appropriate limits. Special attention will be given to large purchases, such as furniture, appliances, home improvements, automobiles, etc. Effort will be made to instill in the family on a permanent basis a habit of keeping a proper balance between income and expenditures.

Evaluation of such projects[20] by impartial observers is essential if any faults are to be corrected and if lessons learned are to be utilized by other agencies engaged in low income consumer education. Early experience indicates that middle and upper income individuals who design and teach such experimental programs face major hurdles in trying to work with consumers from different socioeconomic backgrounds. Results often are disheartening; but, instead of giving up, governmental agencies should use the failures for their own education and the development of better programs.

Programs Vary Widely

The course content, teaching materials and instructional methods of existing programs for adults vary as widely as they do in consumer education for schoolchildren.

Of adult programs offered off-hour in public schools in 1968-69, 64 percent treated "family income management," only 39 percent dealt with "credit", and a disappointing 32 percent touched on "consumer aid and protection."[21] Programs offered by business firms and trade associations emphasize "food consumption, consumer problems in the market (advertising, labeling, weights and measures and the like), and general consumer information."[22] Consumer organizations, labor unions and cooperatives stress consumer protection and legislation.

The literature offered is heavy in quantity and mixed in quality. Information given is sometimes demonstrably inaccurate or misleading. Publications produced both by business and government to explain consumer protection laws often are outdated before they reach readers. Some texts are not appropriately edited for adults. A bank association booklet prepared as a text in adult education courses reads like a third grade primer: "You can divide some words into more than one syllable. Example: mon / ey." Literacy is a problem in many adult groups, but such a lesson is demeaning.

Adult consumer education programs should be designed to appeal to a broad spectrum of people and geared to various income levels, ethnic backgrounds, and

age groupings, with teaching emphasis on development of problem-solving and decision-making skills. Principal deficiencies in existing programs appear to be limited research on their effectiveness and a lack of coordination among various sponsors of the "fragmented array" of projects[23] whose diversity should invite more evaluation. A closer examination of the literature used probably would show that much of it is written by well-educated consumers for others in middle and upper socioeconomic strata and not for the low income consumer.

The Mass Media

Unlike schoolchildren, adults are not a captive audience for consumer education. They need motivation to learn, an effective means of communication, and a message that captures and holds their attention.

Television and radio probably offer the best channels to reach the most people, but only intermittent use has been made of them to transmit consumer credit information. The Federal Trade Commission (FTC) has made script material available for short broadcast spots explaining TIL legislation. The Public Broadcasting Corporation has carried some programs dealing with consumer credit. Local TV coverage of credit topics has been arranged by credit unions in the Far West.[24] A televised daytime serial served as an apparently useful vehicle for communication of consumer information to disadvantaged adults in Denver.[25] There is little reported use by adult educators of "soul" and country western music radio stations which are particularly popular among many low income consumers.

Existing governmental channels have not been used to their full potential as a means of reaching low income consumers. Many receive welfare, housing assistance, or Social Security checks. Others use day care centers or are involved in on-the-job training projects. The lines of communication are there and when used seem to be effective. In Georgia, for instance, consumers started effective use of a free long distance telephone line to register complaints only after the state welfare department printed one-line notices of the service on checks it sent out.

Meanwhile there remains a wide gap between need and realization in the adult consumer education field. *To help close the gap, the Commission recommends use of Federal resources to encourage expanded research and carefully monitored pilot projects to generate and test new ideas in adult consumer education.*

The record of existing programs and old methods, especially among low income consumers in the inner cities, is not satisfactory. Unless consumer education for adults is improved, much of the consumer credit legislation that has been passed—or may be passed—will continue to benefit the affluent primarily, although credit abuses cited by legislators to justify legislation are typically drawn from experiences of the poor.

Consumer Education in Other Countries

Recommendations by the Commission in support of consumer education resemble those made by similar study commissions in other countries. The undereducated consumer is not a peculiarly American phenomenon.

The Select Committee of the Ontario Legislature on Consumer Credit recommended that:[26]

> The Legislature direct the Department of Education to provide consumer credit instruction for young people in the secondary school curriculum as part of an existing course of study, such as household economics or mathematics.
>
> The Legislature direct the appropriate Department of Government to provide consumer credit information to the adult population, using booklets, pamphlets, mass advertising media and other modern methods in co-operation with financial and commercial organizations.

More recently the Crowther Committee, established to examine consumer credit in the United Kingdom, concluded:[27]

> It is our belief that the most rewarding long-term method of familiarizing people with the credit system is through the schools.
>
> . .
>
> Whilst such measures will help to reduce consumer ignorance in the long run, they will do little to combat existing deficiencies in the knowledge of the adult population. One way in which the situation can be improved is by courses at adult education centres, where there is no necessity for a set curriculum and within limits instruction can be arranged on any subject in which a sufficient number are interested to form a class. . . In particular, the Consumer Council urge that television and radio should be used more extensively for the purpose of education and advice about credit.

Remedial Education

For many consumers preventive education is not only too little but too late. This was demonstrably true for

the 182,143 who filed for personal bankruptcy in the fiscal year ended June 30, 1971.[28] Although these bankruptcies involved only 88 individuals per 100,000 of population, they represented disaster for the families involved. The resultant credit losses were reflected, however indirectly, in higher costs paid by other credit users.

No clear relationship between lack of general education and financial defaults has been established. In a study of debtors in default, David Caplovitz found that 61 percent in his sample had not finished high school compared with 47 percent of the population as a whole.[29] A Brookings Institution study of a broader geographical sample of bankrupts found that poorly educated groups were represented generally in the same proportion as their ratio in the population.[30] In any case, association of education with level and stability of income blurs any direct correlation of education and default. One thing is sure: People who cannot meet their debts are in dire need of counseling and remedial consumer education.

Much informal counseling is offered by credit grantors. Additional advice is provided to those customers who run into trouble and ask to have their contracts rewritten. Family service agencies provide credit counseling in many cities and so do a few credit bureaus and legal aid offices. More formal counseling is given by nonprofit services and by commercial debt adjustors.

Nonprofit Services

Nonprofit credit counseling originated in Ohio in 1955 when the Capital Finance Corporation of Columbus established a free credit counseling service operated then by Economy Budget Service Company.[31] Since then the National Foundation for Consumer Credit has fostered expansion of similar services, numbering more than 100 by the end of 1971. The Office of Economic Opportunity has supplied limited funds for debt counseling in a few legal aid offices.

Clients of a nonprofit counseling agency, which itself provides no credit, usually are referred by creditors or by various community agencies. The usual procedure is to work out a budget providing for extended time payments to the agency, which then reallocates them to the creditors. Penalty charges accumulated by debtors often are canceled when payments are rescheduled.[32] Debtors may be charged at most nominal fees for agency services, the bulk of whose costs are paid by participating creditors.

In general, nonprofit counseling services are too few and too inadequately financed to provide clients with the detailed instruction they may need to avoid future trouble. The Family Service Association found in one survey that 75 to 95 percent of staff time was devoted to preparation and administration of payment plans, leaving little time for the remedial education of clients.

Some of the major classes of credit grantors give little or no support to the National Foundation for Consumer Credit and Consumer Credit Counseling Service. Many local credit grantors—often those whose practices contribute much to consumers' credit difficulties—refuse to participate in or help finance the services. In some communities private debt adjustors have been able to prevent establishment of nonprofit agencies.

Opposition from the legal fraternity to agency counseling which might encroach on a lawyer's jurisdiction often inhibits the agency from telling a client about his legal rights and remedies, including the right to file foi bankruptcy. Since agencies rely on creditors for what financial support they can muster, they are doubly reluctant to appear to promote bankruptcy or to challenge the legal standing of any debt.

The Commission recommends that business organizations support and encourage nonprofit credit counseling provided it is conducted for the benefit of the consumer and does not serve solely or primarily as a collection agency.

Services for Fees

Since about 1950, private business firms—known variously as debt poolers, budget counselors, and prorators—have offered services on a fee basis to problem debtors. These firms perform essentially the same functions as nonprofit agencies and, like them, provide no credit. A sampling of cases of a commercial debt adjustor in Illinois showed that slightly more than 20 percent of amounts paid by debtors went to the firm, the balance to creditors.[33]

By the end of 1971, following many reports of numerous abuses connected with commercial debt pooling, 28 states had laws prohibiting debt adjusting except when related to legal counseling or nonprofit counseling services.[34] Another dozen or so states have laws regulating operation of private debt adjustors, but the adequacy of the legislation and its enforcement is open to question. Although Article 7 of the Uniform Consumer Credit Code was reserved for "Consumer Credit Counseling," as yet no proposals have been forthcoming. There appears to be little hope for beneficial consumer education by private debt adjustors, although undoubtedly there are exceptions among them.

The Commission sees regulation of commercial debt adjustors as the duty of the States—a responsibility which has not been met in some cases. *If private debt adjusting services are allowed to continue, the Commission recommends strict regulation and supervision of their activities, including their fees and advertising.*

496-072 O - 73 - 15

Roles of Bankruptcy Courts

Bankruptcy may relieve the symptoms of credit mismanagement, but is, by no means a cure. A study of 75 consumers who filed for bankruptcy in 1956 showed that 7 years later 80 percent had unsatisfactory credit records indicating repossessions, suits, and charge-offs. Another 9 percent had filed for bankruptcy again.[35] This high rate of recidivism probably could be reduced if financial counseling were coupled with bankruptcy proceedings.[36]

If the role of the bankruptcy court is to try to rehabilitate debtors as well as to resolve legal claims against them, court arrangements for counseling and consumer education should be appropriate. Bankruptcy Referee Joe Lee of Kentucky pointed out in a paper submitted to the Commission:[37]

> Such counseling would be consistent with the role of the probation service in view of the recognized relationship between financial dependence and crime. Certainly, debtors, no less than criminals, are entitled to the rehabilitation services of the government.

Several debtor education projects conducted more or less informally in conjunction with bankruptcy proceedings already are under way. Referee Lee, himself, has started one in conjunction with the School of Social Professions at the University of Kentucky. Social workers and community agencies are enlisted by Referee Conrad K. Cyr at Bangor, Maine for a voluntary program in which debtors are given help in putting their family affairs into better order. The Brookings Institution report on bankruptcies recommended that counseling be made available to debtors to help them comply with wage earner plans under Chapter XIII of the bankruptcy laws.

Meritorious as these experimental projects are, the Commission does not believe they go far enough. *The Commission recommends that counseling be made a mandatory requirement for obtaining a discharge in both Chapter XIII and straight bankruptcy, unless the counselor in a particular case should determine that counseling would be unnecessary or futile.* Such counseling should be conducted under the aegis of the bankruptcy court by trained persons paid from general revenues, not only court-generated funds.

Studies of consumers in financial difficulty reveal that domestic troubles, emotional stress and related factors often are root causes of their debt distress. Therefore, counseling should not only be geared to providing advice on credit but to finding the real origins of a consumer's problems and searching for solutions. Counseling should focus not only on the petitioner but on the petitioner's family and its personal or spending problems that underlie the financial difficulties leading to filing of the bankruptcy petition.[38]

Even mandatory bankruptcy counseling may be inadequate if the debtor does not apply the guidance received to the systematic repayment of his debts. Only through some on-the-job training in debt management can many consumers gain practical experience in budgeting—to limit desires to available resources. It is, in part, for this reason that in Chapter 3 the Commission strongly recommended provisions to make Chapter XIII more attractive. The Commission views the expanded use of Chapter XIII as a necessary accompaniment to professional counseling under the aegis of the bankruptcy court.

Summary

A hallmark of the American economic system is that consumers have choices in their acquisitions of goods and services—cars, refrigerators, canned soup, credit, whatever—which are offered in the marketplace in wide array.

The system will not work as it should if large numbers of consumers lack the judgment to make intelligent decisions in purchases to serve their needs. They should know what they are doing, and why, when they cast their dollar ballots in the economic democracy of the market. They should be educated consumers, and too often they are not.

To the extent that the cost does not exceed the value it helps to have laws that require sellers to make available information pertinent to buyers' decisions. It is essential that consumers understand how to use this information when they shop for goods and for credit to finance their purchases. Disclosure legislation is only as effective as the informed use consumers make of the disclosures.

The Commission has a special interest in consumer education, particularly in schooling which leads to the wise use of credit. Consumer education should start at the primary school level and continue through adulthood. It should be designed to aid buyers in making market choices which are right for them. And, it should impose no life style standards on the consumer.

Consumer education at all academic levels should be made more meaningful for consumers, and particularly for consumers in lower socioeconomic strata—those who can be presumed to need it most. It is primarily for their benefit that the Commission urges Federal expenditures to encourage the development of innovative consumer education programs more relevant to the marketplace.

Chapter 12

THE FUTURE OF CONSUMER CREDIT

The mission of the Commission would not be fulfilled without some attempt to predict the probable future of consumer credit, both to highlight opportunities to improve credit services for consumers and to warn of possible infringements upon consumer sovereignty in the marketplace. Thus, the Commission must try to assess how consumers use and regard credit so that their needs and desires are not thwarted by credit grantors' actions or improvident legislation. The identification of the underlying trends in the demand and supply of consumer credit is the objective of this chapter.

The Commission has examined the general demand-supply conditions in the money and capital markets and, more specifically, in that portion gravitating to "consumer credit." It has also considered the future role of the newest and most dynamic form of consumer credit—open end or revolving credit, now fostered by millions of credit cards issued by a wide variety of banking and nonbanking firms. Because of revolving credit's popularity, its future growth must take place in an openly competitive arena if consumers are to benefit fully from its development. Furthermore, the appropriate relationship of credit cards to the emerging electronic funds transfer system[1] represents a basic economic and legislative issue that must be dealt with at an early stage. These relationships are made even more complex by the likely entrance into the marketplace of new suppliers of consumer credit as well as by an increase in the variety of services offered by existing credit grantors.

DEMAND-SUPPLY CONDITIONS IN MONEY AND CAPITAL MARKETS

It is extremely difficult to insulate that part of the money and capital markets which comprises consumer credit from other segments. Capital is mobile, and this very mobility provides an effective means of shifting resources in the economy to their most productive uses. Consequently, if interest rates are high, they are likely to be high throughout the various parts of the money and capital markets although there may be various leads and lags among market segments over time.[2] Because of the mobility of capital, attempts to reduce interest rates in one part of the market are likely to drive funds out of that segment into more rewarding uses. Thus, interference with the free market may produce "savings" for the small number of credit users who will be served in the "protected" portion of the market, but any gain is at the expense of those who can no longer be provided credit at the reduced rates. Since the market for consumer credit cannot (and should not) be insulated from the rest of the money and capital markets in our type of economic system, the future of consumer credit should be examined by trying to assess the future aggregate demand for and supply of funds.

Demands for funds

The coming years will make heavy demands on the money and capital markets to finance a variety of needs. Unless the supply of funds readily matches the demand, interest rates are likely to be high in all segments of the market, including consumer credit. A number of factors will cause increased demands for borrowed funds.

First, many billions of dollars will be required by government and industry to meet environmental problems. Such outlays will be especially burdensome on money and capital markets because they represent a bulge necessary to deal with many years' accumulation of problems. Other areas of neglect that will also drain funds from the market are facilities for medical care, for the aged, and for prison reform.

Second, industry will seek additional funds to modernize plant and equipment, both to offset rising wage costs and to compete more effectively in world markets. The same will be true of the service industry. The American consumer spent about 43 cents of every dollar on services in 1971 compared with only 33 cents in 1950. Yet over this same period the price index for services (less rent) rose 134 percent, compared with 56 percent for nondurable goods and only 32 percent for durable goods. If these inflationary pressures are to be stemmed, vast sums must be spent to increase productivity in the service area.

Third, increasing demands to remedy "urban blight" will drain funds from the money and capital markets into housing, transportation facilities, police and fire protection, schools, and the many other facilities needed to revitalize our cities. In the long run these investments will yield a counterflow of funds to the money and capital markets, but in the short run there will be a substantial net outflow of capital. Although the needs of the cities may be met to some extent by revenue-sharing, this will not materially influence the amount of funds drained from the market; it will only determine the route of funds to the cities.

Finally, consumers will also demand more funds from the money and capital markets. The high rate of family formation anticipated during the remainder of the 1970's will be accompanied by increased demands for credit to finance the "capital equipment" needed by young families: homes, automobiles, furniture, and the like. Consumer credit is used most frequently by family heads in the 25-34 age bracket (Chapter 2, Exhibit 9) and between 1971 and 1980 the number of individuals in this age bracket will rise by almost 11 million, an increase of 42 percent. This contrasts sharply with an increase of only 2.8 million in the 35-59 age bracket, a growth of less than 5 percent.[3]

Although the shift in population age structure will cause a higher proportion of the population to use consumer credit, the very rapid growth in consumer credit outstandings that followed immediately after the end of World War II is unlikely to recur. Most of the new markets for consumer credit, such as the financing of boats, trailers, and the like, have been tapped. New forms of consumer credit may be devised, but they are likely to represent only minor variations on the basic "modern" form of consumer credit: revolving credit. Even a lengthening of maturities will not have the same impact that it did in 1955-56. Over time a shift of maturities on new automobile credit from 24 to 36 months increased outstandings by 50 percent. But a further lengthening of maturities to 48 months would increase outstandings by only one-third.[4] A leveling off of living standards would also remove pressures to incur instalment debts and thereby reduce the growth rate of consumer credit.[5] Consumers *are* curtailing their use of credit in relation to their disposable incomes (Chapter 2, Exhibit 11). Although consumer credit will certainly grow along with other forms of credit, its rate of growth may be somewhat less rapid than in the past.

Even a slowdown in the growth rate will still lead to a very large *absolute* increase of outstandings. From year-end 1960 to year-end 1971, outstanding consumer credit grew from $56.1 billion to $137.2 billion, a compound annual growth rate of 8.5 percent. If an 8 percent compound annual growth were maintained through the balance of the 1970's, outstandings at year-end 1980 would amount to $274.3, an absolute increase of over $137 billion. A compound annual rate of growth of about 9.1 percent would be necessary to bring outstandings at the end of 1980 to $300 billion.

Supply of funds

Capital outlays to meet the accumulated problems of preserving our environment have a different impact upon the economy from typical expenditures for plant and equipment. For the most part outlays to prevent pollution do not generate profits. Instead, most of the "profits" realized by society are in the form of cleaner air and water, and much of the improvement in living standards may not be captured by statistics on the gross national product. Indeed, profits are very likely to be reduced by pollution-control expenditures because there may be a lag in passing on to consumers the cost of improvements in the form of higher prices for goods and services. Ultimately, price increases in automobiles, for example, to pay for safety features and antipollution devices will dampen the demand for these products and diminish correspondingly the derived demand for consumer credit to finance their purchase. Unless government intervention offsets these events, their impact could be expected to reduce the supply of funds to money and capital markets.

The rise in prices required to offset outlays on pollution controls and to provide safety features for consumer products is really not inflationary except in some statistical sense. However, there is also likely to be continued inflation, whether of the cost-push variety or of the demand-pull type in any fully-employed society. This has a very direct impact on the money and capital markets. In seeking to counteract inflation, investors demand a higher price for their funds to offset the loss in real income occasioned by the rise in the price level. Also, investors may divert funds from savings institutions and channel them into real goods—land and homes—in an effort to hedge against inflation, especially rapidly rising building costs.

The same shift in the age structure of the population that will generate a greater use of consumer credit is likely to add to inflationary influences by diminishing the supply of personal savings. As a group, young married couples are "net debtors" because of their greater need for willingness to use consumer credit and mortgage credit rather than to save prior to purchase of consumer goods and services.

Price of funds

Thus, prices in the money and capital markets are likely to remain high relative to the very low levels recorded from 1935 through 1965. Since the Nation experienced a depression and war and the aftermaths of each during that period, the 1970's may represent a more "normal" period in the money and capital markets. Because of the mobility of capital, interest rates in all segments of the financial markets will probably remain fairly high over the next decade unless artificial means are used to favor particular segments. However, favoritism accorded some segments of the market must be offset by higher rates in other segments.

Under these projected conditions, price competition for consumer credit promises to be more vigorous than in the past. With a slowdown in the rate of increase in consumer credit and with fewer additions to the types of goods and services financed, credit grantors in the future are relatively more likely to rely on price competition than on nonprice competition. This shift in emphasis will be materially aided by a number of other developments in the marketplace, the most important of which will be a greater knowledge among consumers of credit terms and the annual percentage rate as required by the Truth in Lending law. Growing awareness and understanding of the annual percentage rate will affect flows of funds in the household sector on both the demand and supply side. But as more consumers move into income brackets where they have a choice among credit grantors, they will compare the prices of credit more efficiently than in the past. Consumer comparative shopping will undoubtedly be aided by improved educational programs (Chapter 11). On the other hand, credit grantors will find savers more sensitive to rates paid with the result that these rates will also become more comspetitive. In short, credit grantors stand a good chance of finding themselves squeezed between the rates they can obtain for extensions of credit and the rates they must pay to obtain loanable funds.

GROWTH OF REVOLVING CREDIT

The rapid growth in popularity of revolving or open end credit arrangements, such as check-credit plans, revolving charge accounts, and overdraft checking arrangements, suggests that this form of credit will be increasingly significant in the future. Large department stores and gasoline station chains issued credit cards as early as 1914. However, the introduction of modern retail revolving credit is usually attributed to Wanamaker's of Philadelphia in 1938. From those beginnings revolving credit outstandings of retailers grew rapidly to a level at the end of the first quarter of 1972 of about $11.7 billion.[6] Bank charge-card credit originated in 1951, and check-credit plans in 1955. By April 30, 1972, outstandings under these two forms of revolving credit were almost $3.5 billion and $1.4 billion respectively. Finance companies have only infrequently experimented with revolving credit, mainly because of restrictions by laws in many states. However, a number of credit unions have recognized their members' interests in this form of credit by designing effective revolving credit programs. For example, the Pere Marquette Employees' Credit Union may establish a line of credit as high as $5,000 for a member who may then draw at will against the line by using a simple request voucher by mail or at any office. Since monthly payments are made in amounts of $26 per $1,000 of loan balance, the implied maximum maturity is almost 40 months. No data are available showing aggregate outstandings under similar revolving credit plans at credit unions.

Reasons for growth

During the last 15 years, outstandings under one form or another of revolving credit have grown from very small amounts to about $17 billion. Their rapid growth demonstrates that revolving credit plans are favored by consumers and creditors alike. From the standpoint of consumers, the major advantage is convenience and cost, since extensions of credit may be arranged almost at will and do not require separate or prior negotiation in each instance. Treatment of each credit transaction as part of a continuing arrangement significantly reduces the cost of these credit extensions to consumers. Moreover, the arrangement can at any time be terminated voluntarily by the consumer without incurring further finance charges. Since a consumer's maximum liability for unauthorized use of a credit card is now limited to $50, the use of credit cards reduces his risk of losing cash and provides him with records of goods and services purchased. In addition, a credit card is probably more readily acceptable than a personal check especially when presented outside a customer's home town. As one economist has summarized, the "economics of information attached to the credit card reduce the cost of obtaining instalment credit on the part of the user."[7]

Creditors find that revolving credit permits them to grant small amounts of credit in successive transactions without incurring the high acquisition and processing costs that would be required if each transaction were treated separately. By establishing a revolving credit account only once and then monitoring the consumer's use of the account, credit grantors are able to spread the acquisition cost over many subsequent transactions.

Creditors still must bear the cost of funds invested in outstanding balances and the costs of handling each transaction and the monthly collections.

Available data on revolving credit plans of retailers and commercial banks demonstrate the economies of this method of handling credit extensions. A recent study of large and small retailers showed that consumers with active revolving credit accounts had just under 13 transactions per year, with an average amount per transaction of $10.11. Throughout the year the average balance per account was $67.65. For this credit service consumers paid an average of $10.20 per year, or an annual rate in relation to average receivables balances of 14.41 percent.[8] Data relating to BankAmericard customers show that they average two purchases per month of about $17 each and carry an average balance of around $250. For this service customers paid on average $46.44 per year, or an annual rate of just over 14 percent on the average outstandings.[9]

The special role of the multiparty bank credit card

The future growth of revolving credit plans cannot be viewed solely in the context of the consumer credit market. Credit cards represent more than just a means of arranging credit both to consumers and to issuers, especially when the issuer is a commercial bank. The dual character of the multiparty credit card involves both opportunity and danger for consumers in their use of credit.

Consumers view the credit card as a currency card with a credit feature. This is shown by the fact that many avoid incurring a finance charge by paying the account within the so-called "free" period. On average, during a given month somewhere between one-third and two-fifths of banks' cardholders use their cards as a substitute for currency and avoid any finance charge. Thus the card serves as a convenient means of accumulating several small "cash" purchases and paying for them on a monthly basis. Since the banks discount the merchants' paper, some portion of the total cost of providing the delayed payment is presumably transmitted to these consumers through the cash price of goods and services. Retailers report that their customers also view their revolving credit accounts as a combination of delayed cash payment and credit service. A recent survey of retailers showed that about 7 percent of the active revolving credit accounts did not incur a finance charge at any time during the year surveyed. Of all active accounts in any one month, just over 16 percent were paid in full as if they were in fact "30-day accounts."[10] Reports from a major retailer indicate that these percentages are largely representative of current experience. Travel and entertainment cards and oil company cards are used primarily as short-term convenience credit rather than to obtain instalment credit.

The position of commercial banks as suppliers of revolving credit offers an interesting anomaly. On the one hand, banks have made an enormous investment in the credit card system. A majority of credit card banks are linked in a nationwide interchange that continues to expand. While balances on bank cards now make up 29 percent of revolving credit outstandings, they accounted for over one-half of the total increase in this field during the last 3 years. Almost 10,000 banks offer credit cards, though more than four-fifths are agency banks; that is, they do not own the receivables they generate. Over 1,150,000 merchants are members of the two leading systems and serve an estimated 62 million card-carrying consumers.[11]

On the other hand, many banks report substantial losses on their credit card operations although it should be noted that the extent of losses is clouded by an absence of uniform accounting and reporting procedures:

> Losses on bank credit-card operations are continuing at a high rate. The banks which reported in the informal Federal Reserve survey last August had a net loss on their credit-card operations in 1970 equal to 1.8 percent of their year-end outstandings. Their net credit charge-offs during the year amounted to 2.5 percent, and fraud losses 0.63 percent, of year-end outstandings.[12]

Some of these losses are attributable to start-up costs and to unexpected fraud losses. As plans mature, losses tend to decline and profits to emerge. Nonetheless, only one-third of the banks surveyed in the study reported above recorded a net profit on credit card operations in 1970.

The relationship of multiparty credit cards to EFTS

Why should commercial banks continue to make a heavy commitment to credit card plans in the face of such losses? In part, the losses are temporary. Experience shows that profits on credit cards emerge once a bank brings its costs under control and raises the number of active accounts. But banks also fear to remain outside the credit card system, because they view it as the forerunner of the *electronics funds transfer system* (EFTS). To a substantial extent the research and development necessary to the growth of the credit card interchange system also provide the basis for the EFTS, more commonly known as the "cashless" or "checkless" society.

In an absolute sense the introduction of credit cards and check-credit plans has increased the flow of paper through an already overburdened system. The use of credit cards has probably encouraged credit rather than cash purchases and delayed repayments, and consumers still pay their accounts by check. An overdraft banking service (check-card) is also available to finance shortages of funds for depositors. A cash advance privilege permits a cardholder to obtain cash, within a limit. Each credit card voucher for a credit sale or cash advance must be generated and then processed by hand. Out of the accumulated sales slips the bank must compile monthly statements which the bank hopes will encourage an incoming wave of checks from consumers. This cumbersome system is tolerated not only because of anticipated profits, but because of the next phase that is still waiting in the wings, the electronic funds transfer system.

ELECTRONIC FUNDS TRANSFER SYSTEM (EFTS)

The developments in the payment system and the technological advances in the computer industry provide the impetus for the emergence of the cashless-checkless society through the EFTS. Most experts envision three major elements in an EFTS. The first is a unique personal identifier for each consumer that would have a number and means of identification such as a voiceprint or fingerprint. It will be the successor to today's bank credit card. The identifier would serve as a "money card" and it, rather than cash or checks, would be used to draw and disburse funds.

The next major component in an EFTS is an on-line banking system in which every bank has a computer capability. The banks would be linked to a regional computer center that would serve as a local clearing house and as a link to a national network. The regional computer center could also serve as a credit bureau.

The third vital element is an on-line system for retail merchants. A remote terminal device would be installed on the retailer's premises and this device would be on-line to the regional computer center. As a result, it would be linked to the banks in the area, and by virtue of the national network, the retailer would also be linked to banks and to other retailers across the country.

The operation of an EFTS would be simple and efficient. A consumer who wished to make a purchase would insert his "money card" in the retailer's remote terminal device. After a hook-up with the regional computer center and the bank, the cost of the purchase would be deducted from his account. If there were insufficient funds in the account, the customer could elect to use his overdraft privilege or cash advance privilege based on a preauthorized line of credit. The credit extension would be automatically available provided his credit record was satisfactory. At that point, a green light would flash on the terminal device, and the retailer would complete the transaction by directing the funds to his own account.

If the consumer wished to make a purchase exceeding his preauthorized line of credit, a yellow caution light would flash on the retailer's terminal device. The request would be relayed to the regional credit information file where a determination would be made regarding the consumer's credit standing. This information would then be relayed to the bank for credit approval. If the consumer were creditworthy, the loan would be granted, the terminal device would flash green, and the transaction would be completed. The light would flash red if the consumer were a credit risk, and the sale would not be made unless the merchant wished to assume the credit risk.

Plans are under way to supplement this system with an automated electronic procedure to transfer preauthorized payroll deposits and payments on loans and utility bills. The Special Committee on Paperless Entries (SCOPE) of the American Bankers Association has under study and in trial operation a system that provides for the deposit by an employer of a single check for an entire payroll in a given bank and the subsequent distribution of paychecks to banks chosen by the employees for deposit in their accounts. Subsequent preauthorized transfers of funds from the employees' accounts to pay insurance bills, utility bills, loan payments, and the like can also be handled by electronic transmissions through the clearinghouse system.

Obstacles to development of multiparty credit card - EFTS

It would be a great oversimplification to suggest that the system described above and advocated in glowing terms by many is readily achievable. There are a number of obstacles to its development. Some are technical. Others stem from resistance to one or more aspects of the system by retailers, consumers, and legislators. The manner in which these issues are resolved will have a material effect upon the future of this increasingly important segment of consumer credit.

Technical problems. Computer technology is available to permit the abolition of the sales slip and electronic transfer of funds and credit information. A remaining obstacle that is nontrivial is the lack of a generally accepted means of positive identification of the credit cardholder at the point of sale. Some automated cash dispersal systems of commercial banks require that a consumer insert his credit card in a machine and also punch in a series of numbers assigned to him. Since this

system might not be feasible for terminals at retail outlets, some thought is being given to identification of cardholders by use of voiceprints. Thus if a customer presented a card for a relatively large purchase, he would be asked to speak a few words into the microphone of some identification device. "The spoken words would be transmitted to the regional center, where the cardholder's voiceprint would be compared to the spectograph on file."[13] The problem of identifying the cardholder is obviously of considerable importance. Since it seems likely that some solution will ultimately be forthcoming, this appears to be a technical problem that will at most delay, rather than prohibit, the development of the multiparty credit card - EFTS system.

A second technical problem arises in the billing errors that may accompany the proposed system. In view of the millions of transactions currently processed through the credit card system, the number of actual errors and billing complaints represents a minute fraction of the total volume. However, for the consumer who happens to fall within that fraction, "Nothing is quite as frustrating or degrading as to correspond for 6 months or a year with a computer in a vain attempt to straighten out a bill."[14] Although the humans who program and operate the computers cannot be expected to achieve complete lack of error, it is equally clear to the Commission that firms offering revolving credit arrangements must be more responsive to complaints concerning billing errors than has been true at times in the past. Legislation or regulation is needed to protect consumers in their unequal battle with the computer.

Specifically, *the Commission recommends that legislation be enacted to achieve the following goals:*

(1) Each consumer's complaint should be promptly acknowledged by the creditor.

(2) Within a reasonable period of time a creditor should either explain to the consumer why he believes the account was accurately shown in the billing statement or correct the account.

(3) During the interval between acknowledgment of the complaint and action to resolve the problem, the consumer should be free of harassment to pay the disputed amount.

(4) The penalties on creditors for failure to comply should be sufficiently severe to prompt compliance.

Opposition by retailers. Bank credit cards offer small retailers a means of competing more effectively with the large retailers who can operate their own credit plans economically. In essence, the small retailer can transfer his own accounts receivable to the bank and shift a substantial portion of the costs of the credit function to the bank. Not all costs are assumed by the bank, since the retailer has to discount his accounts receivable and still continues to have the incremental costs up to the point of sale, i.e., processing the credit sale, checking the credit standing of the customer if required, and so on. Nonetheless, the discount charged by the bank on its credit card paper is often less than the cost to the small retailer of carrying his own receivables. This is suggested by one study reporting that small retailers showed a deficit of 3.79 percent of sales on their revolving credit plans, compared with a deficit of 2.83 percent of sales for large retailers.[15]

Many large retailers have consistently refused to accept multiparty credit cards for a number of reasons. In some cases they believe the cost of operating their own credit plans is less than the discount required on other credit cards. They have also expressed concern about "losing their identity" and sacrificing their ability to deal directly with customers who need credit. They fear that if one of their customers fails to pay the bank because of his dispute with another retailer, the bank will turn off the consumer's credit at all locations. In addition, retailers use their monthly billings to notify customers of special merchandise promotions. While this is possible with third-party billings, each retailer using the billing would be competing with many others. Finally, retailers realize that it would be dangerous to transfer all of their credit operations to a third party because it would be extremely difficult to reverse the decision. Even though a bank might agree to a discount of, say, only 1 percent of credit sales for an initial period, retailers feel that they would be in a poor position to forestall higher rates in later years. Given the prohibition against the mass mailing of unsolicited credit cards and the normally heavy start-up costs of establishing a credit plan, the retailer who conveys his credit function entirely to a third party places himself in a poor bargaining position by becoming virtually locked into the third party's system.

The failure of large retailers to accept bank credit cards has understandably disturbed bankers. These retailers represent the greater part of the market for credit sales and probably have larger unit credit sales than many small retailers who accept bank cards. Entry into this market would assist the banks in several ways. Since they already have their computer systems, the added volume would provide greater economies in operations so long as there is unutilized computer capacity. Because of the higher average price per sales ticket, they would generate more revenues in relation to the volume of paper handled. Also, they could expect to find more consumers using the credit service rather than paying all or a large portion of the account within the "free" period. These advantages motivate banks to exert considerable pressure on retailers to accept their cards.

So long as these pressures are not in restraint of competition, they are entirely acceptable. Rising costs of providing credit—and in some cases requests by their own customers—have forced some large retailers to accept third-party credit cards, although few have gone so far as to abandon their own credit plans. The Commission believes the danger to consumers' interests lies in retailers' being forced to adopt third-party credit plans by means other than consumers' free choice. This situation could arise if banks were left entirely in charge of the electronics funds transfer system *and* the credit information system. It is important that consumers have options among alternative credit systems with various means of assessing credit charges. In this way each consumer can adopt the credit plans and systems that meet his personal needs. To a considerable extent consumers have these options today in credit markets. The Commission has some specific recommendations to make toward maintaining these options in the future.

Opposition by consumers. Many believe that the only obstruction to the ultimate development of a third-party credit card - EFTS system is the consumer, because human attitudes and behaviors are difficult to change. As an illustration of these deep-seated positions, a recent survey of metropolitan areas in Georgia and Florida showed that about seven-tenths of consumers were opposed to any preauthorized payments of bills.[16] The major objections seem to be that the consumer has no record of payment, no opportunity to correct billing errors, and less freedom in determining when the bill is to be paid. Also, of course, under preauthorized billing, consumers could not delay payment and would lose the float created by check payments.

For many of the same reasons, consumers seem to prefer the present check-writing system to an electronic payment system. In the same survey in metropolitan Atlanta, almost 69 percent of heads of household favored the present check system, just under 18 percent were in favor of the electronic payment system, and about 14 percent had no opinion.[17] Roughly similar responses were obtained in metropolitan areas of Florida. Acceptance of the electronic payments system increased with the level of income, and younger respondents were more favorably inclined toward the "modern" system than older individuals. Although questionnaires concerning hypothetical systems are hazardous, the strong preference for the present check-writing system suggests that successful implementation of the credit card-EFTS will require substantial educational and promotional efforts. Preliminary results from a test in Ohio suggest that in practice consumers can be persuaded to accept such a funds transfer system.[18] In commenting on the implications for the future of its experience with the checkless-cashless payment test, the City National Bank and Trust Company (Columbus, Ohio) observed in its 1971 annual report:

> The customer will have direct access to his bank account via a whole family of on-line devices activated by a machine-readable plastic card. . . It eliminates the time and confusion of checkwriting and recordkeeping. It reduces the risk of carrying cash and simplifies credit arrangements.

But a uniform EFTS will ultimately be necessary to make it workable, just as standardized transfer symbols on checks have become required.

Legislative obstacles. Some bank credit cards have been slow in generating profits, and many apparently operate at a loss. Losses from fraud and processing costs have been greater than expected while revenues have been lower than expected because many consumers pay their bills promptly and thus avoid a finance charge. Revenues have also been reduced by vigorous competition on merchant discounts. The current absence of profits from their credit cards has led some bankers to abandon their plans and others to wonder whether the entry fee to the ultimate EFTS is not too high. If many banks become discouraged and drop out of the credit card field, introduction of the EFTS may be further delayed or concentrated in the hands of a few large banks.

Recently the profit situation has been exacerbated by state legislation to reduce the permissible monthly charge on bank credit card plans (as well as on other forms of revolving credit). In a study of the impact in the State of Washington of Initiative 245, which forced rates on bank credit cards to 1 percent a month, the authors concluded:

> If the present high cost of money persists and the 12 percent revenue ceiling remains in effect, it is quite possible that some banks might drop bank credit cards if net income from this source of business is not forthcoming. One possibility for additional bank revenue would involve a direct annual charge to the consumer for the privilege of using the bank credit card services.[19]

Arguing that the 12 percent rate ceilings imposed in Minnesota prevented profits, the Marquette National Bank of Minneapolis, the major licensee for BankAmericard in the upper Midwest, recently considered instituting an annual $10 membership fee for its credit card customers.[20] In response to similar limitations on revenues, BankAmericard licensees suspended indefinitely accepting new applications for credit cards in Minnesota and North and South Dakota.[21] The spread

of similar limitations on charges of bank credit cards, and revolving credit plans in general, could materially inhibit the development of the multiparty credit card-EFTS. Given the ultimate desirability of this system to handle the transfer of funds and credit economically, the artificial stifling of revolving credit card plans might be viewed as counterproductive to consumers' best interests.

Another legislative problem arises in the area of descriptive billing versus "country club billing." The former type of billing involves printing (usually by computer) on the customer's bill a brief description of the item purchased or possibly a designation of the department in which it was purchased. "Country club billing" typically includes the customer's current sales slips with each month's bill. Regulation Z accompanying the Consumer Credit Protection Act requires that periodic statements for open end credit accounts provide "unless previously furnished, a brief identification of any goods or services purchased or other extensions of credit. . .Identification may be made on an accompanying slip or by symbol relating to an identification list printed on the statement" [Section 226.7(b) (2)]. Thus the regulation permits either country club or descriptive billing.

Those involved with the development of the EFTS point out that descriptive billing is essential to realize the full potentials of the system. Obviously, a requirement that sales slips be prepared and copies sent to consumers with their bills would negate the objective of reducing the flow of paperwork. Provisions could still be made for a consumer to receive a record of the sale at the point of sale. But it would add to the costs of providing credit if legislation required that duplicate copies be gathered and sent along with the bill, as under country club billing.

It is evident from the survey in the Atlanta metropolitan area that consumers will offer some resistance to descriptive billing. Some of this resistance must be attributable to publicity about unsatisfactory relations that a minority of consumers have had with computers. Asked to choose between "A complete listing of check information, as proof of payments, in lieu of canceled checks" and "No change in the handling of canceled checks," 65 percent of consumers favored canceled checks; 18 percent favored a descriptive listing; and 17 percent had no opinion. Just over 28 percent of those aged 25-34 favored the descriptive approach.[22] The study team concluded, however, that "limited bank experiments with descriptive billing, as well as presently operating truncated check flow systems abroad, seem to demonstrate the ultimate acceptability of this aspect of a payment system change."[23] The Commission concurs with this conclusion and recommends that consumers and credit grantors be permitted to work out a gradual accommodation to an economical billing system.

Risks to consumers in development of multiparty credit card - EFTS

If an electronic funds transfer system is ultimately developed and combined with revolving or open end credit, the system must have adequate constraints to assure that consumers receive the benefits to which they are entitled from the system. The Commission perceives significant dangers for consumers underlying current trends in the development of credit cards and the EFTS. Basically, the problems arise because the economies of scale inherent in the development of a massive electronic system for the exchange of funds and credit information lead naturally to oligopoly—that is, control of the industry by a few large credit grantors—with a consequent danger of restraint of competition and denial of its benefits to consumers seeking credit in the future.

Conditions leading to oligopoly and restraint of competition. Certain industries have basic characteristics that naturally lead to oligopoly, or even monopoly. In such industries entry is difficult and, once a firm has entered, it has made a commitment in fixed assets that have little salvage value. Rather than engage in ruinous price competition, the temptation is strong among participants to reach accommodations that restrict competition. In some cases they may obtain legislation or a suitably protective government agency to shield them from unwelcome competition. Whatever the means, the results of such restraints on competition harm consumers. The Commission would find this to be an intolerable result in consumer credit.

The multiparty credit card-EFTS has characteristics that naturally lead to oligopoly. A very sizable investment is needed to provide the funds transfer system. For example, a group of Atlanta banks and the Federal Reserve Bank of Atlanta have estimated that an initial investment of $2 million will be required in their joint venture to establish an electronic clearinghouse to serve banks and a network of point-of-sale terminals at retail establishments. Not only are costly computers required but substantial investment must be made to acquire accounts and to build their level of activity to the point where the program is profitable. Once in operation, there is a great incentive to build volume, since incremental volume may often be handled at little additional direct cost other than the cost of capital invested in the receivables. Abandonment becomes difficult and painful. Sale of the credit card operation to another issuer may salvage some investment, but the sale itself may often lessen competition further.

Evidence suggesting economies of scale is provided by a survey of credit card plans by size of bank. Over

three-fifths of the outstandings at mid-1971 were held by banks with deposits in excess of $500 million; almost nine-tenths of outstandings by banks with deposits in excess of $100 million.[24] In viewing the evidence, one economist has concluded:

> By way of summary on the question of economies of scale, it appears that such economies are not large on the local or regional market level. However, in the national market, scale economies and other entry barriers are probably large and important. This conclusion does not preclude banks of all sizes from participating in national credit card plans, but limits them, in effect, to a franchise or agent arrangement. A potential competitor to BankAmericard or Master Charge faces difficult entry conditions.[25]

Possible harmful effects of oligopoly upon consumers. The tendency for national multiparty credit card systems to be dominated by a few large credit grantors poses significant potential dangers to U.S. consumers. These dangers should be identified in order to design and to justify preventive measures.

First, there are obvious incentives to reach agreement or to take "parallel action" concerning the price of credit. Efforts to restrict price competition are most likely to focus on increasing merchants' discounts and assessing consumers with fixed annual or monthly charges for the use of credit cards.

Competition for retailers' receivables has tended to reduce merchant discounts. This competition has directly benefited credit consumers and has aided cash customers by limiting the credit costs included in the cash price. However, this price competition, coupled with consumers' failure to use the "credit portion" of their bank cards, has also contributed to the losses shown by a number of banks on their credit card plans.

Efforts to restrain this form of price competition may take the form of establishing certain minimum merchant discounts, possibly under the aegis of a bank regulatory agency, in order to "protect depositors." This Commission categorically opposes the establishment by a regulatory agency of minimum merchant discounts. As the EFTS becomes more efficient, competition should be permitted to force merchant discounts even lower if possible. Since collusive setting of merchant discounts is already prohibited by antitrust laws, *the Commission recommends additional Federal and state legislation specifically prohibiting any regulatory agencies from establishing minimum merchant discounts.*

Another possible approach would be for banks to assess a flat annual charge for the use of their credit card, as in the case of travel and entertainment cards. Although there is nothing inherently unfair in such an annual fee, it would be a matter of public concern if both bank credit card systems simultaneously or collusively inaugurated the same annual charge.[26] Similarly, minimum monthly charges are an acceptable means of allocating to credit users some portion of the fixed costs of providing credit on an equitable basis, but a uniform charge, if decreed by law or by mutual agreement among credit grantors, would leave consumers with no desirable variety of credit arrangements.

Second, when credit and fraud losses occur in the initial stages of bank credit card plans, there may be an understandable and justifiable incentive in the short run to narrow the market served under current rates of charge by eliminating high risk consumers and merchants. (As the EFTS becomes more efficient, there should be strong incentives to broaden the base again.) About half of credit card banks responding to a recent survey indicated that they planned to modify their programs; of these, four-fifths expected to screen their new customers' accounts more carefully.[27] To assess the effects of these reactions on consumers, Exhibit 12-1 shows the percentages of Atlanta metropolitan area households with credit cards classified by type of credit card and gross income. Retail credit cards provide the greatest access to the credit market, with gasoline companies, banks, and travel and entertainment cards each demanding progressively higher credit standards as measured by consumers' gross income. Of those households with gross incomes of less than $10,000, only 31 percent had bank credit cards, while 49 percent had one or more retail credit cards. Among the 556 such households surveyed, there were 227 bank credit cards and 577 retail credit cards.[28]

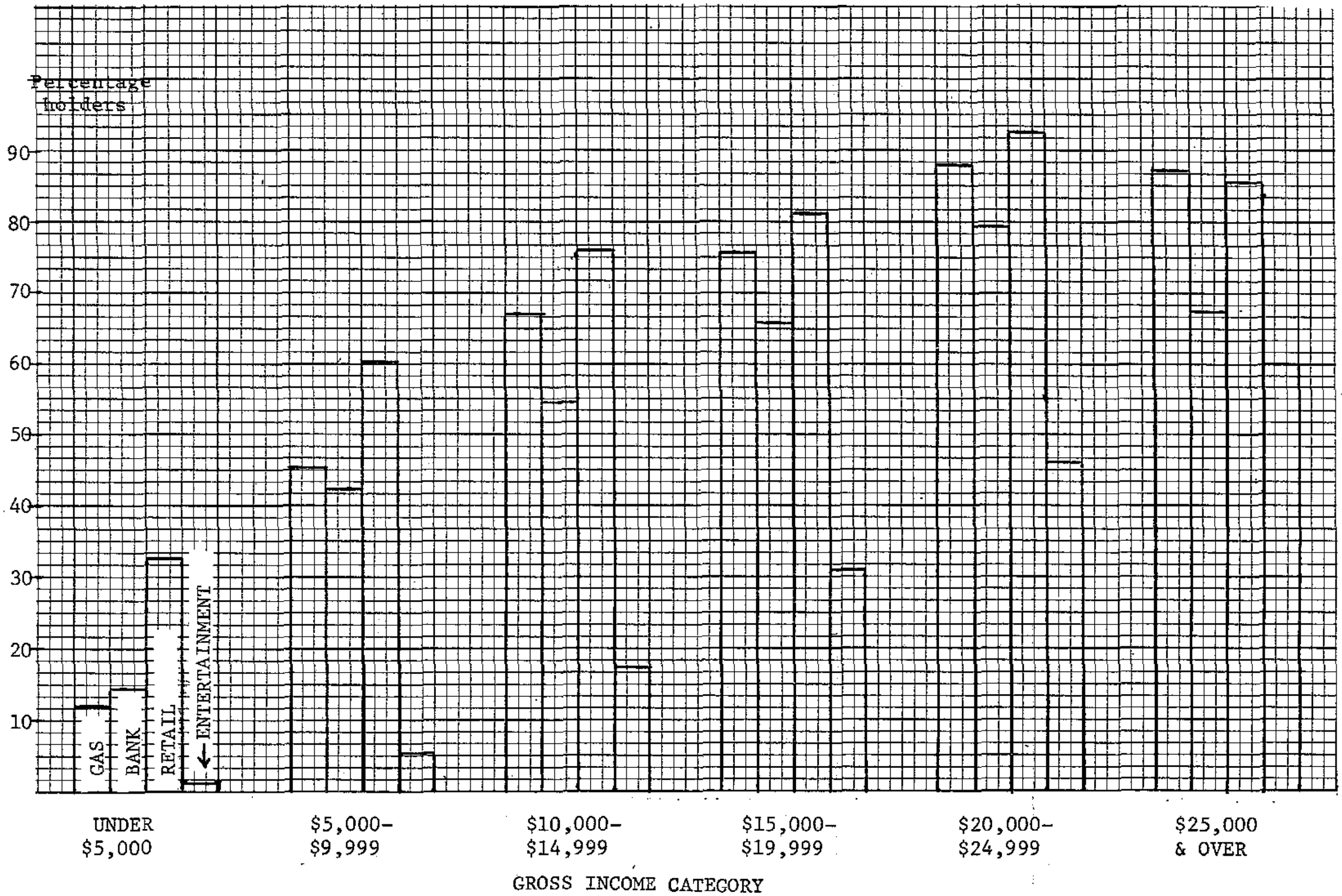
Data from the most recent Survey of Consumer Finances reveal the same dominance of other credit cards over bank cards among families at lower income levels (Exhibit 12-2). Among families with incomes of less than $5,000 who used credit cards, use of other-than-bank cards was about seven times the use of bank cards. Among families with incomes of $15,000 or more, the relative dominance was only about 1.5 to one.

Thus if banks offering credit cards should tighten their credit standards, consumers rejected from that market must turn to gasoline and retail credit cards to remain in the revolving sales credit market. If consumers are to have viable alternatives, these forms of credit cards must be encouraged to survive as vigorous competitors.

Of the banks planning to modify their credit card programs, almost two-thirds planned to eliminate unprofitable merchant accounts.[29] If the merchants excluded by the banks have access to no other credit card plans, they must either bear the substantial burden of carrying their own receivables or be placed at a

EXHIBIT 12-1

PERCENTAGES OF ATLANTA METROPOLITAN AREA HOUSEHOLDS WITH CREDIT CARDS
CLASSIFIED BY TYPE OF CREDIT CARD AND GROSS INCOME CATEGORY



Source: Research on Improvements of the Payments Mechanism, Vol. 3, Table F 4.

EXHIBIT 12-2
Use of Bank Credit Cards by Income Levels

(Percentage distribution of families)

Annual family income	Percentage of families using Bank Cards	Other than bank cards	Total
Less than $3,000	2	14	17
$3,000-4,999	3	21	24
$5,000-7,499	11	28	39
$7,500-9,999	14	40	54
$10,000-14,999	22	45	67
$15,000 or more	33	45	78

Source: George Katona, Lewis Mandell, and Jay Schmiedeskamp, *1970 Survey of Consumer Finances* (Ann Arbor: Survey Research Center, University of Michigan, 1971), p. 33.

considerable competitive disadvantage. Most of the merchants faced with this dilemma are probably small and thinly capitalized. Since credit is often an important ancillary service, especially among retailers selling consumer durable goods, their inability to offer revolving credit—either by exclusion from the bank card system or by the high costs of operating their own plans—would tend to force many small retailers out of business. Their departure would reduce competition among retailers, resulting ultimately in higher prices for a narrower and less convenient assortment of retail goods and services.

Third, there is a natural inclination for an oligopolist to restrain existing competitors and to prevent entry of potential competitors. Such a tendency would prove harmful to consumers. As a possible illustration of this trend, National BankAmericard, Inc.

> . . . adopted a bylaw amendment, effective Dec. 1, [1971] that prohibits its Class A members—basically banks that own and issue BankAmericards—from participating in the competing national bank card programs.[30]

D. W. Hock, the president of National BankAmericard, told this Commission that the reason for the change was to maintain and enhance competition:

> To allow an owner/member of one system to participate in another system would create irreconcilable conflicts of interest, and could, in our view, completely destroy competition between the two systems. Indeed, such dual membership inevitably would lead to the merger of both systems, with the resulting loss of incentive to improvements and innovations which the present keen competition between the two systems fosters.[31]

In July of 1972, however, the Federal District Court in the Eastern District of Arkansas ruled on that BankAmericard bylaw amendment, declaring it "a horizontal restraint of trade or commerce and a per se violation of the antitrust laws." The American Banker of July 21, 1972 reported that the ruling was likely to be appealed to the U.S. Eighth Circuit Court of Appeals in St. Louis.

Legislative or governmental action may also hamper competition. A case in point is the recent enactment of a law in Connecticut permitting a maximum finance charge of 1 1/4 percent per month on balances outstanding under bank credit cards but limiting the charge on retail revolving credit balances to only 1 percent per month.[32] Since the banks also receive a discount from the merchant in addition to the direct charge to consumers, the discrimination established by legislative fiat is even greater than might at first appear. Such deliberate market segmentation results in a lessening of competition to the detriment of Connecticut consumers.

A highly effective means of excluding potential and existing competitors would be control by an instrumentality owned by commercial banks of the electronic funds transfer system (EFTS). As some visualize the system, wages and salaries would be automatically transferred from employers' accounts to employees' accounts at commercial banks. Subsequent automatic transfers from consumers' accounts to pay utility bills, insurance premiums, taxes, instalment payments on debts, and so on could also be arranged through the commercial banking system. Clearly, if the EFTS is established so that the payroll "check" can enter the EFTS only through a commercial bank affiliated with one of the two national credit card systems, the two organizations will be able to exercise considerable

control in determining which consumers receive credit and from whom the credit can be obtained.

Since the development of the EFTS is presently occurring through private enterprise, the Commission is not prepared at this time to recommend transfer of exclusive responsibility for the system to a government agency at the possible expense of creativity and innovation potentially available through private enterprise. Although economic forces may dictate that control of the EFTS will ultimately rest with only a very few firms, this domination of the EFTS would not necessarily deter competition in the granting of credit. However, the strong potential for restraint of competition leads this Commission to call attention to the public policy issues posed by the development of an electronic funds transfer system and to recommend that Congress consider the need for future regulation of the system to assure users and consumers the full benefits of effective competition.

One necessary condition to achieve this goal is to require that membership in the funds transfer system be open to all credit granting institutions and that all have third party transfer privileges. In taking this position, the Commission finds itself aligned with the President's Commission on Financial Structure and Regulation, which recommended that:

> under specified conditions, savings and loan associations and mutual savings banks be permitted to provide third party payment services, including checking accounts and credit cards, to individuals and nonbusiness entities only.[33]

Credit information system. The future of consumer credit will be materially affected by the nature and control of the credit information system. Although the efficiency and equity of the present system have been materially improved by the Fair Credit Reporting Act, issues remain involving privacy and control of the system.

Protection against the invasion of privacy in the computer age must be achieved by balancing the need to preserve privacy against the desire to maximize benefits of efficiency inherent in the new technology. There are no statutory guidelines upon which such a balancing can be based. In addition, since the computer industry is a relatively young one, there has been little litigation and case law that would establish principles to apply to the balancing of privacy and progress.

In the absence of clear statutory or judicial guidelines, some fear that the computer information industry will be given the privileged status of the communications industry and will be judged by the First Amendment standards established for the press. If those standards were adopted for the computer industry, an invasion of privacy could not be established unless the complaint alleged that the private information was given publicly or communicated to the public at large. This requirement would probably prove to be an ineffective means of protection against computer invasion of privacy, since rarely would computer information be published. Rather, a different standard must be created that would limit the nature of the computer information disclosed as well as the audience to which it is disseminated.

The Fair Credit Reporting Act promises equitable handling of consumers' credit records if properly enforced and assurance of privacy will probably grow as case and legislative law evolves. There remains, however, the very crucial question of who will control the credit reporting system. Resolution of this issue is critical to consumers' ability to obtain adequate amounts of credit at reasonable prices.

The present fractionalized credit reporting system does not appear adequate even to the needs of the present. Many cities host several consumer credit reporting agencies—some controlled by banks, some by retailers, some by finance companies and some independent. Certain credit grantors are outside the system, neither reporting credit experience nor making inquiries. This dispersion of credit information permits consumers to build excessive debts by failing to reveal all of their current obligations in credit applications.

The deficiency in the present credit reporting system has been noted by Representative Leonor K. Sullivan:

> It goes back to the original idea I had 15 years ago that I think we ought to have a central spot in the United States where all credit risks can be cleared . . . [W]e ought to have some place—and I do not say the Government necessarily should do it, some good credit firm could do it—where we would have a nationwide credit agency and when anyone has so much credit outstanding that it reaches a certain amount of his income he could not get credit until he reduced what he owed. That would put a credit limit on some of these "credit addicts."[34]

While the system is deficient in the existing environment, it is likely to be more so in the future. The trend in state legislation, as evidenced by the Uniform Consumer Credit Code and other state laws, is to require credit grantors to rely less on formal collection devices and remedies, such as cognovit notes, holder in due course, wage assignments, garnishments, and repossession with deficiency judgments. As the usefulness of these collection remedies diminishes, creditors in the future will necessarily rely more heavily on consumers' willingness and ability to pay. Knowledge of a consumer's credit record and current obligations will become

paramount to the responsible granting of credit. These data are, of course, to be found only in the records of one or more credit reporting agencies.

The increasing importance of data housed in credit reporting agencies is of major importance both to consumers and credit grantors. On the one hand, consumers must be assured of the accuracy of the information. If a security interest in his automobile or an assignment of his wages proves to be inadequate because of limitations on creditors' remedies, a consumer must rely on credit reporting agencies to demonstrate that he has a record of meeting his obligations promptly and that he has not accumulated excessive debts. If inaccuracies in the records show him to be a poorer risk than is actually the case, he will either be denied access to credit or be required to pay a higher price than justified, which, in either situation, is unsatisfactory.

On the other hand, credit grantors are also concerned that credit records be comprehensive and accurate. There must be no barrier to the prompt flow of adequate credit information into and out of the data base. *Any laws or action or inaction by industry that impede these flows also lower the availability of credit and raise its price to consumers.* But the data must also be accurate. Failure to show past delinquencies and omission of some current obligations can allow credit grantors to extend credit that is improvident, both from their point of view and the consumer's.

The demands for *accurate, comprehensive,* and *current* credit information from consumers and industry reinforce other pressures bringing about a consolidation of credit reporting agencies. First, the nature of the demand for information requires rapid storage and retrieval of information—a function that can be handled efficiently only by computers. Computer technology obviously favors large, centralized credit reporting agencies. Second, the mobility of the population and the growth of credit cards demand a nationwide system of credit information.

Finally, the emergence of the electronic funds transfer system means that whoever controls and operates that system will also have a record of credit extensions and payments. Consequently, if commercial banks continue to enlarge their share of the consumer credit market and if the bank card-EFTS becomes a reality, commercial banks will not only control the funds transfer system but they will own the major portion of the available credit information. Moreover, banks will be under no obligation to share credit information with competing firms whose own credit information will become progressively less reliable as banks enlarge their share of the market. In short, if the banks' current dominant role in credit cards is coupled with control of the EFTS and, by extension, ownership of the credit information system, those banks dominating these systems will be in a position to exercise significant control over the market for consumer credit. If only two credit card plans emerge as part of EFTS, a large and growing portion of consumer credit in the United States will be controlled by a two-system oligopoly with a potential for restraint of competition in the market for consumer credit.

It appears to the Commission that in the long run the credit reporting industry has the ingredients of a public utility. It is as uneconomical to have three credit bureaus in town as it is to have three telephone companies. The necessity for accurate and comprehensive credit data, the technology, the mobility of the population, and the emergence of the multiparty credit card - EFTS all argue for a single credit reporting agency for each metropolitan area linked with similar agencies throughout the nation. But it is surely not in the public interest to grant a monopoly to one credit reporting agency without both regulating its freedom to set prices and requiring that it provide open access to its store of credit information to all credit grantors. Open access is vital, since any creditor denied entry to the credit information system must either charge exorbitant rates to cover his risk or severely limit the granting of credit. Although the development of credit reporting agencies as public utilities is not imminent, *the Commission recommends that studies be undertaken now to consider the eventual Federal chartering and regulation of credit reporting agencies, both to assure the accuracy and confidentiality of their credit information and to achieve open and economical access to their data.*

Additional consumer protections needed

In addition to these recommendations to achieve needed consumer protections relating to EFTS, the Commission charges legislators to encourage competition among credit grantors, especially in the field of revolving credit.[35] In every aspect possible, all credit grantors should be accorded equal treatment under the law with respect to rate ceilings, conditions under which they may grant credit, maturities, permissible amounts of credit, disclosure requirements, and collection remedies. Dr. Robert Lanzillotti summed it all up:

> In the final analysis, consumers stand to benefit from increased competition within and among bank card credit, travel and entertainment card credit, oil company card credit, and others. Product, service, and geographic markets of banks are broadened appreciably, and banks are stimulated to make credit available in more imaginative ways. Providing access to this market, by firms other than banks, or in

conjunction with banks, should be conducive to a more competitive market structure, more competitive behavior among the suppliers of credit services, and lower credit charges to users.[36]

Painful as competition may be for the participants, it provides the ultimate protection for most consumers. Coupled with the shopping information provided by Truth in Lending legislation, increased competition is favored by the Commission as the best means to assure that most consumers pay a fair price for their credit services. There are problem areas where competition, under current laws, is ineffective. In particular, the problem of low income consumers living in low income areas requires special attention (Chapter 10).

FUTURE CHARACTERISTICS OF CREDIT GRANTORS

The future growth of consumer credit is likely to bring some new entrants into the list of credit grantors. In addition, current trends suggest that credit grantors will provide even more diversified services to consumers than at present. Thus the future will probably bring more competition and convenience to American consumers in their use of financial services.

New entrants

A number of arguments have been advanced to permit savings and loan associations and mutual savings banks to expand their currently limited powers to make consumer loans. Grebler argues that permitting thrift institutions to make consumer loans "would go a long way in moderating the cash flow problems that result from imbalance in the term structure of the assets and liabilities of thrift institutions."[37] A large portion of thrift institutions' liabilities are, in essence, short term, while the assets (mortgages) are long term. The addition of consumer loans to portfolios would increase the ratio of cash inflows to total loans outstanding, thereby improving the liquidity position of lenders. However, it cannot be argued that cyclical fluctuations in consumer credit will offset variations in mortgage credit so that cash outflows will be stabilized. Examination of recent cyclical movements in residential housing starts and consumer credit indicates that their peaks and troughs coincide closely.[38] Unless thrift institutions are willing to stifle a cyclical expansion in demands for consumer loans in order to meet needs for mortgage loans, it is difficult to see how the improved cash inflows will in fact bolster the financing of owner-occupied homes.

It has also been argued that the net yield on consumer loans is higher on consumer loans than on residential mortgages. Data from the 1970 functional cost analysis for average banks prepared by the Federal Reserve System are suggestive.[39] However, the data assume the same rate of charge for cost of capital to each function, regardless of differences in portfolio risk. Nonetheless, added cross-competition among mortgage lenders and grantors of consumer credit should serve to assure that the spread between net yields is commensurate with differences in risk.

The President's Commission on Financial Structure and Regulation recommended that thrift institutions obtain limited powers to make consumer loans.[40] This Commission recommended elsewhere in this report (Chapter 7) that thrift institutions be given the authority to extend consumer loans. The added competition provided by these new entrants can be expected to make consumer credit more available and to bring even more downward pressure on finance charges.

Diversification

In institutions which grant consumer credit, diversification may serve two purposes. It may reduce the risk assumed by the credit grantor if the variability of his expected returns decreases. Or, it may improve his income by providing a more attractive mixture of services for customers. In either case there must be effective competition to force credit grantors to share these benefits with consumers.

Diversification to reduce risk. Other things being equal, credit grantors who diversify their loans geographically assume less risk than those restricted to a given locality because regional variations in income, employment, and output tend to be greater than variations in the national average. For this reason, artificial restrictions on branching by credit grantors or limitations on their freedom of entry into markets are counterproductive from the point of view of consumers.[41]

Diversification into various forms of financial services also serves to reduce the risk of credit grantors. Returns from services such as automobile loans, mortgage loans, and the sale of mutual funds and life insurance are not perfectly correlated. As a result, when credit grantors provide more financial services, they reduce the variance of their returns and, by extension, their risk. Again, however, there must be effective competition to force the lowered risk from geographic and product diversification to be transmitted to consumers in the form of greater credit availability and lower finance charges.

It is likely that large commercial banks which are members of the Federal Reserve System, or their holding companies, will soon open "operating subsidiaries" or "loan production offices" across the Nation, either *de novo* or by acquisition of existing finance companies.

This has been made possible by the Comptroller of Currency's Interpretative Ruling 7.7376, *et. seq.* In addition, the Board of Governors of the Federal Reserve System ruled that such operating subsidiaries are not branches (and therefore not subject to branching restrictions) if they perform the following activities, individually or collectively:

> . . . soliciting loans on behalf of a bank (or a branch thereof), assembling credit information, making property inspections and appraisals, securing title information, preparing applications for loans (including making recommendations with respect to action thereon), soliciting investors to purchase loans from the bank, seeking to have such investors contract with the bank for the servicing of such loans, and other similar agent-type activities.[42]

Operating subsidiaries of this type should provide Federal Reserve member banks with diversification both on a geographical basis and across forms and risk classes of credit. The Commission approves this development as one more means of increasing the level of effective competition in the market for consumer credit.

Diversification to lower costs. Not only should diversification reduce risk, but it should also reduce costs of credit grantors. Since diversification frequently involves invading competitors' markets or combining credit and other services in a package attractive to consumers, it tends to increase competition among different segments of the credit industry. This greater competition should help to force creditors to share their lowered costs with consumers in the form of greater availability of credit and lower finance charges.

Adding to the variety of services provided consumers may enable credit grantors to obtain some economies of scale. Available evidence does not clearly indicate the range of assets over which economies of scale may be experienced. However, if economies do exist over some range, their realization should benefit consumers.[43]

It also seems both likely and desirable that grantors of consumer credit will provide a wider range of financial services to consumers in the future. It should be possible to credit grantors other than commercial banks to provide "one-stop financial services" for U.S. consumers. So long as existing prohibitions of tie-in sales of goods and services are enforced, consumers will benefit if credit grantors are permitted to experiment in the offering of such services as the sale of mutual funds, trust services, leasing, and the sale of various forms of insurance, in addition to providing all forms of consumer and mortgage credit.

It is difficult to predict the mixture of financial services that will eventually be offered by credit grantors. The important point is that whenever possible the mixture should be established by competition within the marketplace rather than by legislation destined to divide the market to protect some credit grantors from the whip of competition. Thus the laws governing various credit grantors should be as uniform as possible to allow competition to become effective. In this context the Commission views as anticompetitive and, therefore, anticonsumer the introduction of amendments designed to segment consumer credit markets.

There are also prospects for greater diversification across risk classes of consumers.[44] At the present time, for example, most finance companies typically charge the same rate to all customers wanting a loan of a given size. Similarly, most banks charge the same rate to all loan applicants requesting a personal instalment loan, although they may grant some single-payment or demand-note loans at a lower rate to consumers with very high credit standings. As a result of market segmentation by legislated loan limits and legal rate ceilings, finance companies tend to grant smaller loans to higher-risk borrowers while commercial banks typically provide larger loans to lower-risk borrowers. As techniques for evaluating credit applicants become more sophisticated and accepted, and as credit information becomes more reliable, each credit grantor is likely to broaden his scope of acceptable credit risk if legal barriers are removed, so that the price charged for credit directly reflects the perceived probability of being repaid. Such risk differentiation is now common on commercial loans made by banks and on issues of commercial paper and long-term bonds.

In this connection it is worth noting that the low rate ceilings imposed on loans by credit unions and banks effectively prevent them from achieving as much diversification across different risk classes of their customers as credit grantors permitted higher rates. Members whose credit standing prevents their obtaining loans from their credit union must seek loans elsewhere, often at considerably higher rates than they would have been charged if credit unions could diversify more efficiently. Consideration should be given to following the lead of a number of Canadian Provinces in permitting higher rate ceilings for credit unions. While some credit unions and banks would probably choose not to diversify across risk classes, others would at least have that opportunity. Even if not exercised, the *opportunity* to invade another firm's market serves as an effective check on that firm's treatment of its customers.

SUMMARY

In the foreseeable future a supply of funds will be insufficient to meet all of the pressing requirements for modernization of plant and equipment, environmental

496-072 O - 73 - 16

protection, research and development, housing, and the other prerequisites of an improving real standard of living. Because of the capital rationing process that will ensue, the price of consumer credit is unlikely to be reduced significantly below current levels. However, for many individual consumers, value received in relation to the price charged promises to be greater for a number of reasons. As a means of providing the type of credit apparently desired by consumers, revolving credit is less costly than the alternative forms of closed end credit that would be needed to provide the same service. When joined with the electronic funds transfer system, the ubiquitous credit card will reach its full capabilities as a convenience cash card and as a means of ready access to a line of credit. Because the credit grantors supplying revolving credit through the electronic funds transfer system control both access to the system and the supply of credit information generated, it is essential that the future funds transfer and credit information systems not become means of restraining competition in the market for consumer credit. To assure an adequate supply of credit to consumers at reasonable prices, Congress should consider the need for future governmental regulation of privately operated electronic funds transfer and credit information systems. Membership in the EFTS should be open to all credit grantors and all credit grantors should have economical access to the credit information system. If control of these systems becomes progressively more concentrated, it seems likely that such concentration will necessitate that these firms be treated as public utilities.

Consumers should also be able to shop more effectively for credit in the future because of increased competition. Over time consumers will recognize that striking down legal barriers prohibiting credit grantors from providing some types of consumer credit will widen their opportunity to finance their purchases of goods and services at lower cost. As artificial distinctions between forms of credit and suppliers of credit disappear, so will the differences between cash credit and sales credit blur. Aided by the disclosure provisions of Truth in Lending, consumers will shop more effectively for different forms of credit and among a greater variety of credit grantors.

SEPARATE STATEMENTS

OF

COMMISSION MEMBERS

SENATOR JOHN SPARKMAN

By writing this individual view, I by no means wish to imply that the Commission has not done a masterful job in its work and on its Report. The Report contains any number of worthwhile recommendations, many to which I subscribe and agree. On the other hand, there are some recommendations contained in the Report to which I cannot subscribe or agree without additional information and further study. This is why I cannot agree with the Report in its entirety.

I have always supported recommendations and legislation designed to benefit the consumer if in doing so we could strike a delicate balance so that the consumer is, in fact, protected without, at the same time, denying him credit and without driving up the cost of consumer goods and items as well as credit. In my opinion, some of the recommendations in this Report do not accomplish this delicate balance and I fear would have a more adverse effect on the consumer than they would inure to his benefit.

While the Report expresses the attitude of maintaining this balance, it proceeds in certain recommendations to question whether this balance will be maintained. I therefore feel that in those areas of question, additional study and consideration are necessary before I can support such recommendations. For example, the Report recommends the abolition of the holder in due course doctrine and the waiver of defense clauses. Many states have already taken the doctrine and the waiver into consideration and have passed legislation modifying their effect as has my state, the State of Alabama. However, in recommending the abolition of the doctrine and the waiver, the Report also suggests that commercial lenders could become the policemen of consumer goods and services. I am reluctant to endorse the recommendation because of its possible effect on small business merchants and small manufacturers as well as others. I am also concerned because of the vast amount of power it could place in the hands of financial institutions for approving the financing of particular brands of consumer products and services.

Other recommendations which give me difficulty are those dealing with the supervision and enforcement of consumer laws. In this area, I think we must be extremely careful in the authority and powers that are delegated to any consumer agency especially as that agency may be given authority to intervene in matters relating to other Federal or state supervisory agencies.

In addition to the above, I cannot endorse this Report in its entirety because of staff suggestions contained in Chapter 7 of the Report, "Rate and Availability of Credit." These suggestions appear to me to sanction the imposition of unconscionably high rates of interest on loans made by those people who can least afford those rates. I realize, of course, that the recommendations regarding rate ceilings are made only if they are taken in conjunction with other recommendations contained in Chapter 7 such as "freedom of entry into the consumer credit field" and the "size and maturity of loans." I do not subscribe to the rate ceiling recommendations because I fear that some jurisdictions would not take all the recommendations but would simply use those concerning interest rates to justify their position to increase these rates.

SENATOR WILLIAM PROXMIRE

I generally concur in the separate views of Congresswoman Leonor Sullivan which are appended to the Commission's report. In addition, I wish to register a sharp dissent to the language, analysis and conclusions contained in Chapters 6 and 7 dealing with interest rate ceilings. I am particularly concerned that Chapter 7 may be interpreted as an endorsement of the staff's recommendations that interest rates on small consumer loans be increased to 42%. The transmittal letter to this report clearly indicates that the Commission did not endorse these staff recommendations. Nonetheless, the language of Chapter 7 is sufficiently ambiguous, so that the intent of the Commission can be subject to serious misunderstanding. While Chapter 7 does not specifically endorse higher interest rate ceilings, it does refer favorably to various staff studies and suggests that the states consider raising their interest rate ceilings in accordance with those staff studies.

It is unfortunate that the Commission report does not take a clear position on interest rate ceilings. Despite a number of pro-consumer recommendations in other areas, I am fearful that they will be largely ignored and that the credit industry will seize upon the analysis contained in Chapter 7 as a justification for higher interest rate ceilings. Finance companies, banks and other creditors have continuously lobbied state legislatures for higher rate ceilings. The Commission's report, together with the separate studies of its staff, could give these creditors new ammunition for their campaign. They will be able to point to a seemingly impartial and scientific report to buttress their arguments for higher interest rate ceilings. Thus there is a real danger that the net impact of the Commission's report and studies will be to raise interest rates without achieving the other reforms which the Commission considers desirable.

Even if the Commission's report could be accepted as a total package, I do not believe higher interest rate ceilings are justified. The Commission report argues that higher ceilings will increase the availability of credit to consumers and particularly to marginal credit risks and that existing ceilings frequently deny credit to worthy borrowers who are then forced to forego borrowing altogether or to deal with illegal lenders at much higher rates of interest.

I believe the Commission's conclusions in this area are faulty on two grounds. First, the Commission's research has not demonstrated with clear and convincing evidence that higher interest rate ceilings will substantially increase the availability of credit. Second, even if the availability argument is accepted, the Commission's report fails to adequately consider the undue burden which higher interest rates will place upon consumers.

Before discussing these two objections to the Commission's conclusions, let us examine in greater detail exactly what the Commission seems to be recommending. Chapter 7 describes the studies conducted by the staff which purport to show that existing interest rate ceilings have reduced the availability of credit. The reader is referred to a staff study, "The Impact of Legal Rate Ceilings on the Price and Availability of Credit," for guidance in devising a structure of legal rate ceilings which would allow workably competitive markets to develop.

Later on, the report makes further reference to the studies by the staff when it states that: "The Commission suggests that those states whose current rate ceilings constrain the development of workably competitive markets consider raising their rate ceilings if they seek to increase credit availability at reasonable rates of charge. The Commission's staff through estimated cost, statistical and other studies has determined that a rate structure with an average APR of 22-26 percent for loans up to and including $3,000 would provide an opportunity for the development of workable competition in consumer credit markets. Further, a Commission staff study has provided guidelines as to how to graduate rate ceiling structures to assure that loans of all sizes will be made. The Commission recommends that states adopt a similar approach to changes in rate ceilings in other consumer credit markets."

In order to grasp the full implications of the Commission's recommendations, it is necessary to have more knowledge of the staff studies which are not included in the Commission Report but which will be published separately at a later date. By referring generally to these staff studies without discussing the specific conclusions reached by the staff, the report can be seriously misinterpreted. The report and the separate staff conclusions on interest rates will be read as a package and some people might consider the staff recommendation for higher interest rates as coming from

the Commission as well as the staff despite the disclaimer contained in the report's transmittal letter.

Unfortunately, all of the staff studies on interest rates were not available to Commission members to review at the time comments were due on the Commission's final report. The Commission is thus in the strange position of making recommendations on a highly controversial subject on the basis of staff studies which it has not seen.

Despite these difficulties, the main conclusions of the staff studies on interest rates can be inferred from an earlier draft report prepared by the staff for specific endorsement by the Commission. This draft report read as follows:

"This Commission proposes an interim rate structure which would

"1) Subject loans up to $100 to a test of unconscionability rather than rate ceilings

"2) Apply the following rate ceilings on:

Loans up to $300–42 percent, APR, and on those portions of the loan

from $301 - 1,000–21 percent APR

over $1,000–15 percent APR

"The decision to replace rate ceilings with an unconscionability standard for loans of $100 or less was based on the knowledge that such loans could not be made without subsidy at rates below 100 percent per annum without sharply limiting their availability, given the Commission's study of the small loan industry in Texas. Although the market for small loans in Texas is workably competitive and rates of charge are justifiable in terms of the cost of extending credit, the Commission believes that instead of making *all* such loans legal, the loans made should be individually subject to court review if borrowers believe they are unconscionable.

"It should be noted that the above rate ceilings are recommended to apply only to personal instalment loans and to secured retail instalment sales transactions on credit sizes up to $3,000. On secured retail instalment sales transactions over $3,000, the Commission recommends a flat 15 percent ceiling APR."

Elsewhere in its report, the Commission specifically recommends that commercial banks be permitted to loan at rates permitted finance companies. Thus the staff recommended ceiling of 42% on loans under $300 would apply to banks and retailers as well as finance companies.

While the foregoing language was not approved by the Commission, I understand that similar recommendations will be contained in the separate staff studies to be published after the Commission's final report. It is customary and proper for the Commission staff to publish data and other factual information as an appendix to the Commission's report. However, it is highly unusual and improper for the staff to publish its own policy views which were never approved by a majority of the Commission. Such a procedure is confusing and could lead to the erroneous impression that a majority of the Commission agrees with the policy conclusions of the staff.

Because there is a possibility that the Commission's views might be confused with the staff views, I believe it is necessary to make my own position absolutely clear. I am unalterably opposed to the higher interest rate ceilings recommended by the staff in an earlier draft report. I am especially opposed to the repeal of all interest rate ceilings on credit transactions under $100. Such a proposal can only lead to the revival of the notorious loan shark industry which has been put out of business in all but a few states. I also believe an interest rate ceiling of 42% on credit transactions under $300 is entirely too high and borders on the unconscionable. Since the Commission report did not see fit to discuss these staff recommendations in any detail, I am presenting my own critique of these recommendations.

The interest rate ceilings recommended by the staff are substantially higher than existing ceilings established by the states as shown in Table I. If a consumer borrows $300 for 12 months from a finance company today, he can be charged interest up to 22.08% in Delaware or as high as 41.70% in Mississippi. On a nationwide basis, the average interest rate ceiling for this type of loan works out to 31.45%. By comparison, the Commission staff would permit him to be charged 42%, an increase of over 10 percentage points. In terms of dollars, under existing ceilings a borrower would pay an average finance charge of $53.51 for a 12-month $300 loan. Under the staff recommendations, he could be charged as much as $72.54, an increase of over 35%.

It is difficult to estimate the increase in interest which would be paid on a nationwide basis if the staff recommendations are adopted. There is a strong tendency for interest rates to approach the ceiling rate in the finance company market although not all lenders charge the ceiling rate, especially on larger size loans. Thus, a 10 percentage point increase in the rate ceiling would probably result in a less than 10 percentage point increase in the average interest rate actually paid on finance company loans. An increase in the average interest rate of around 5% would seem to be a more realistic and perhaps conservative estimate.

Table I also compares existing ceilings on commercial bank loans with the staff recommendations. For a 12-month, $300 bank loan, the states have established interest rate ceilings which run as low as 8% and as high as 29%. On a nationwide basis, the average interest rate ceiling for this type of loan is 13.1% and the average

Table I

Comparison of Commission Staff Recommended Interest Rate Ceilings with Existing Ceilings

	Finance Co. $300 12-mo. cash loan		Bank $300 12-mo. cash loan		Retailer $300 12-mo. Installment Sale		Auto Dealer $3000 36-mo. New Car Installment Sale	
	Finance Charge in Dollars	Annual Percentage Rate	Finance Charge in Dollars	Annual Percentage Rate	Finance Charge in Dollars	Annual Percentage Rate	Finance Charge in Dollars	Annual Percentage Rate
Commission Staff Recommendation . .	$72.54	42.00%	$72.54	42.00%	$72.54	42.00%	$743.86	15.00%
Existing Ceilings, National Average, Weighted by Pop.	$53.51	31.45%	$21.69	13.10%	$33.74	20.13%	$720.11	14.51%
Alabama	58.56	34.26	45.00	26.62	45.00	26.62	720.00	14.45
Alaska	62.52	36.50	19.15	11.58	30.00	17.97	780.00	15.68
Arizona	61.68	36.00	24.00	14.45	30.00	17.97	720.00	14.45
Arkansas	-	-	16.50	10.00	16.50	10.00	484.86	10.00
California	49.44	29.14	16.50	10.00	30.00	17.97	1080.00	21.20
Colorado	61.56	36.00	19.86	12.00	42.12	25.00	922.56	18.33
Connecticut	51.00	30.03	19.86	12.00	-	-	630.00	12.83
Delaware	37.08	22.08	14.82	9.00	30.00	17.97	630.00	12.83
D.C.	-	-	19.01	11.50	-	-	720.00	14.45
Florida	62.52	36.50	25.44	15.30	30.00	17.97	720.00	14.45
Georgia	57.12	33.47	18.00	10.90	36.00	21.46	720.00	14.45
Hawaii	62.76	36.58	19.86	12.00	40.80	24.22	1285.44	24.85
Idaho	61.56	36.00	24.93	15.00	61.56	36.00	1037.76	20.44
Illinois	55.32	32.47	13.17	8.00	48.00	28.33	720.00	14.45
Indiana	61.56	36.00	16.50	10.00	61.56	36.00	1037.76	20.44
Iowa	60.72	35.46	19.86	12.00	-	-	747.60	15.07
Kansas	61.68	36.00	30.00	17.97	18.00	20.29	630.00	12.83
Kentucky	61.68	36.00	26.52	15.93	-	-	810.00	16.24
Louisiana	66.96	38.94	-	-	-	-	743.86	15.00
Maine	51.00	30.00	19.86	12.00	-	-	630.00	12.83
Maryland	61.68	36.00	32.52	19.44	36.00	21.46	810.00	16.24
Massachusetts	49.44	29.14	49.44	29.14	30.00	17.97	720.00	14.45
Michigan	51.72	30.42	33.00	19.72	36.00	21.46	540.00	11.08
Minnesota	56.28	33.00	19.15	11.58	-	-	720.00	14.45
Mississippi	72.00	41.70	27.00	16.22	-	-	630.00	12.83
Missouri	45.00	26.62	13.17	8.00	36.00	21.46	630.00	12.83
Montana	60.00	35.07	33.00	19.72	33.00	19.72	630.00	12.83
Nebraska	51.00	30.00	30.48	18.25	30.00	18.00	747.24	15.07
Nevada	57.00	33.40	26.09	15.68	36.00	21.46	1080.00	21.20
New Hampshire	40.44	24.00	16.50	10.00	-	-	630.00	12.83

Table I

Comparison of Commission Staff Recommended Interest Rate Ceilings with Existing Ceilings—(Continued)

	Finance Co. $300 12-mo. cash loan		Bank $300 12-mo. cash loan		Retailer $300 12-mo. Installment Sale		Auto Dealer $3000 36-mo. New Car Installment Sale	
	Finance Charge in Dollars	Annual Percentage Rate	Finance Charge in Dollars	Annual Percentage Rate	Finance Charge in Dollars	Annual Percentage Rate	Finance Charge in Dollars	Annual Percentage Rate
New Jersey	$40.44	24.00%	$15.79	9.58%	$30.00	17.97%	$630.00	12.83%
New Mexico	58.44	34.22	21.00	12.68	36.00	21.46	720.00	14.45
New York	45.84	27.08	19.15	11.58	30.00	17.97	630.00	12.83
North Carolina	54.00	31.72	25.44	15.30	-	-	796.92	16.00
North Dakota	50.52	29.73	19.15	11.58	30.00	17.97	630.00	12.83
Ohio	48.00	28.33	13.17	8.00	45.00	26.62	782.88	15.74
Oklahoma	51.00	30.00	16.50	10.00	51.00	30.00	984.84	19.48
Oregon	61.68	36.00	24.00	14.45	-	-	720.00	14.45
Pennsylvania	55.32	32.47	19.15	11.58	24.00	14.45	540.00	11.08
Rhode Island	61.56	35.94	35.21	21.00	35.21	21.00	1068.91	21.00
South Carolina	67.92	39.46	21.00	12.68	-	-	630.00	12.83
South Dakota	51.00	30.00	24.00	14.45	-	-	747.60	15.07
Tennessee	50.88	29.96	19.15	11.58	30.00	17.97	-	-
Texas	54.00	31.72	24.00	14.45	36.00	21.46	675.00	13.69
Utah	61.68	36.00	16.50	10.00	61.68	36.00	1064.40	20.92
Vermont	42.00	24.91	19.15	11.58	30.00	17.97	630.00	12.83
Virginia	51.00	30.00	26.04	15.65	-	-	-	-
Washington	61.68	36.00	19.86	12.00	19.86	12.00	587.15	12.00
West Virginia	58.56	34.26	19.15	11.58	-	-	-	-
Wisconsin	42.84	25.42	21.96	13.25	-	-	630.00	12.83
Wyoming	61.56	36.00	16.50	10.00	61.56	36.00	1037.76	20.44
Puerto Rico	60.00	35.07	14.82	9.00	39.00	23.19	630.00	12.83

Source: *Cost of Personal Borrowing In the United States,* 1972 Edition, Financial Publishing Company, Editorial Supervisor, Charles H. Gushee.

finance charge is $21.69. Under the staff recommendations, the interest ceiling would rise to 42% and the corresponding finance charge would increase to $72.54, or more than three times the current charge.

It is even more difficult to estimate the increase in interest charges actually paid on bank loans if the staff recommendations are adopted. Many banks would probably be reluctant to raise their rates up to the higher ceiling because of image problems. However, an increase of 5% would appear to be a minimum estimate of the potential rise in bank interest rates.

Table I also compares the existing interest rate ceilings on installment sales transactions (other than auto sales) with the staff recommendations. For a $300 installment credit sale payable in 12 months, the states have established interest rate ceilings which run from a low of 10% to a high of 36%. On a national basis, the average interest rate ceiling is 20.13% and the average finance charge is $33.74. Under the staff recommendations, these ceilings would be more than doubled to an interest ceiling of 42% and a corresponding finance charge of $72.54.

It is doubtful that all retailers would double their finance charges if the staff recommendations are put into effect. Nonetheless, some increases would be likely and a rise in the interest rate of 5%, or one quarter of the potential increase, would seem to be a reasonable estimate.

Table I also compares the staff recommendations for interest rates on auto loans with existing ceilings. For a $3,000 36-month new car auto loan, the states have established interest rate ceilings ranging as low as 10% and as high as 21%. On a nationwide basis, the average ceiling is 14.51% and the average finance charge is $720.11 for this type of credit. The Commission staff recommends a ceiling of 15% with a corresponding finance charge of $743.86.

For this type of credit, the staff recommendations are only slightly above the average existing ceiling. However, it should be noted that 17 states have established interest ceilings higher than the 15% recommended by the staff. The staff does not recommend that ceilings in these states be reduced to 15% because it claims its data is not precise enough to justify a decrease in interest rate ceilings although it is precise enough to justify an increase in the states below 15%. While one is puzzled by the asymmetry of this logic, let us assume it is accepted by the states. If the states with interest ceilings below 15% raised them to 15% and if the states with ceilings above 15% retained their existing ceilings, the average interest ceiling for this type of credit would increase to 16.54% or more than two percentage points above the existing average ceiling of 14.51%. While it is difficult to predict how much interest rates actually paid would rise, an estimate of one percentage point, or one half the potential increase, would appear reasonable.

The results of all these estimates are summarized under Table II which applies the estimated increase in interest rates paid by consumers to the amount of credit outstanding in the four consumer credit markets just discussed. If the foregoing estimates are correct, consumers will pay an additional $3.5 billion in interest to finance companies, banks, and retailers. This estimate may be conservative and the actual increased interest payments may be more than double the estimate if creditors raise interest rates up to the maximum ceilings recommended by the Commission staff. It is also possible that in the long run, some of the increase in interest rates may disappear if the other Commission recommendations for improving the competitiveness of consumer credit markets are adopted. Nonetheless, by any reasonable estimate, there will be significant short term costs to consumers in the way of higher interest rates and these costs are likely to persist for a considerable period of time.

The estimate of $3.5 billion in higher interest payments was developed on short notice without the benefit of computers or access to the voluminous data collected by the Commission staff. Undoubtedly the estimate is subject to further refinement. However, considering the resources available to the Commission and the length of time it has had to analyze its data, it is unfortunate and indeed surprising that the Commission staff itself did not estimate the potential cost of its own recommendations. One also wonders how seriously the staff considered alternative methods for channeling credit to needy borrowers unable to obtain credit in today's market. A government loan or loan guarantee program might achieve this objective without costing anywhere near the estimated $3.5 billion which consumers will pay if the higher interest rate ceilings recommended by the Commission staff are adopted.

Although it does not endorse any specific rate ceiling structure, the Commission report argues that higher ceilings will increase the availability of credit. It reaches this conclusion on the basis of econometric and other statistical studies by the staff which purport to show that lower rate ceilings decrease credit availability. By relying on econometric techniques, the report seeks to impart an aura of scientific validity to its conclusions. But on closer examination, these conclusions are not supported by the Commission's data with the degree of confidence normally associated with scholarly research. Indeed, the staff argument for higher interest rate ceilings seems to be more a product of an ideological bias against government price regulation typical of

Table II

Estimate of Cost of Commission Staff Recommended Interest Rate Ceilings

Type of Credit	Amount of Credit Outstanding July 1972 (Billions)	Estimated Percentage Point Increase in Interest Paid if Staff Rate Ceilings Adopted	Additional Interest Paid by Consumer (Billions)
Finance Co. Personal Loans	$ 15.8	5 %	$ 0.8
Bank Personal Loans	12.2	5 %	0.6
Retail Installment Sales	33.2	5 %	1.7
Auto Loans	41.7	1 %	0.4
Total	$102.9		$ 3.5

professional economists rather than a detached and objective analysis of the data.

This is not to suggest that it is wrong to have intellectual biases. We all have them. However, we should not permit these biases to masquerade as scientific certitude. There is an unfortunate tendency on the part of those unfamiliar with econometric techniques to stand in awe of mathematical formulas and to accept uncritically conclusions which are highly debatable.

A good example of this tendency is demonstrated in a mathematical equation developed by the staff which purports to show a positive statistical relationship between interest rate ceilings and credit availability on the part of finance companies. In other words, the higher the rate ceiling the more credit is extended, all other factors being equal. From this, the Commission report has concluded that raising interest rate ceilings will increase credit availability.

The problem with using econometrics to reach policy conclusions is that the real world is vastly more complicated than a mathematical equation. There are many variables which affect the availability of credit in addition to the rate ceiling. Indeed, the staff included ten variables in its equation for predicting the availability of credit, yet these ten variables were able to explain only 68% of the interstate variation in credit availability. Moreover, variables other than the legal interest rate ceiling were far more important in determining credit availability. These included the rate of unemployment, median family income, wage rates of employees in consumer finance companies, the degree of economic concentration in the finance company industry, and the growth rate of finance companies. A change in any one of these factors would have a greater impact on credit availability than a comparable change in the rate ceiling variable used in the equation. Indeed, the statistical analyses conducted by the staff show that 70 to 75% of the variation in credit availability is due to factors other than interest rate ceilings.

The staff equation also shows that rate ceilings by themselves do not materially affect credit availability. For example, if a state were to raise its average interest rate ceiling on finance company loans from 20% to 30% (a rate increase of 50%), the equation predicts that credit availability would increase by only 9%. Moreover, even this result is uncertain. According to the staff's own estimates, there is a 23% probability that the observed statistical relationship between credit availability and rate ceilings may be due to chance rather than to any real cause-effect relationship. A 23% probability of error exceeds the tolerance level normally contained in scholarly research. Most academic researchers will not conclude there is a real relationship between two variables unless the probability of statistical error is less than 5% or in many cases, 1%.

Perhaps in partial recognition of the ambiguities in the staff formula, the Commission report seeks to support its policy conclusions through other statistical techniques. The report "selects" eight states with relatively low rate ceilings for finance companies and eight states with relatively high ceilings. (See Exhibit 7-13A and 7-13B of Chapter 7). This analysis shows that credit availability in the eight high ceiling states is more than double the credit availability in the eight low ceiling states.

There are three major deficiencies in this technique. First, the comparison ignores the impact of other factors which are far more important in determining credit

availability. These include median family income, the rate of unemployment, and the other variables contained in the staff formula and described above.

Second, by comparing extreme cases, the relationship between rate ceilings and availability is exaggerated. Most states lie between these two extremes and in their case, the extent of the relationship between rate ceilings and availability may be very slight.

Third, the report does not describe how the 16 states were "selected." Almost anything can be proved by a judicious selection of examples.

As an illustration of the hazards involved through a simple comparison of selected groups of states, Table III shows the relationship between credit availability and rate ceilings in 14 selected states based on data from a previous study. The table shows seven states with relatively high rate ceilings for finance companies and seven states with lower ceilings. If the theories in the Commission's report are correct, one would expect to find that credit availability is greater in the high ceiling states. And yet just the opposite occurs. Credit availability in every one of the seven lower rate ceiling states is greater than in any of the seven high ceiling states. The seven high ceiling states had an average rate ceiling of 31.74% for a $500 finance company loan while the seven low ceiling states had an average ceiling of 27.85%. Contrary to the theory expressed in the Commission report, availability in the low ceiling states was almost four times greater than availability in the high ceiling states.

This is not to suggest that an increase in rate ceilings will reduce credit availability. Table III simply demonstrates the pitfalls of selecting a small group of states to prove a point while ignoring the impact of other factors which may be more important.

The same statistical fallacies underlying the Commission's report are shown in Table IV which describes the relationship between rate ceilings and bad debt reserves

Table III

Relationship Between Rate Ceiling and Credit Availability at Finance Companies for Selected States

State	Rate ceiling for a $500 loan	Dollar amount of loans made per 1,000 households
Seven Higher Ceiling States		
Florida	34.07%	$121
Oregon	33.63%	12
Washington	32.46%	102
Montana	32.38%	77
South Dakota	30.76%	133
Minnesota	30.07%	51
Iowa	28.85%	57
Average per State	31.74%	79
Seven Lower Ceiling States		
Nevada	28.64%	200
New Hampshire	28.31%	207
Ohio	28.31%	204
Virginia	28.03%	165
California	27.58%	170
Michigan	27.46%	1035
Missouri	26.64%	177
Average per State	27.85%	308

Source: Michael Kawaja, *Regulation of the Consumer Finance Industry,* Graduate School of Business, Columbia University, New York (1971) table C-1, pp. 96-98. (Data is for the year of 1964)

Table IV

Relationship Between Rate Ceiling and Bad Debt Reserves at Finance Companies for Selected States

State	Rate ceiling for a $500 loan	Reserve for bad debts as a percentage of average loans outstanding
Five Higher Ceiling States		
Idaho	33.63%	1.7%
Washington	32.46	2.8
Kansas	30.96	2.5
New Hampshire	28.31	1.8
Ohio	28.31	2.9
Average per State	30.73	2.3
Five Lower Ceiling States		
Massachusetts	27.58%	3.0%
Michigan	27.46	3.3
Illinois	27.33	2.9
Vermont	25.69	3.5
New York	23.13	2.9
Average per State	26.23	3.1

Source: Kawaja, op. cit.

at finance companies. If the theory of the Commission report is correct, one would expect to find an increase in bad debt reserves as rate ceilings are increased. This is because higher rate ceilings bring in more revenue and thus permit finance companies to extend credit to more marginal credit risks where the expectation of loss is greater. Table IV examines this theory for five selected states with high rate ceilings and five states with lower rate ceilings. Bad debt reserves are 35% higher in the lower rate ceiling states, which is the exact opposite of what one would expect from the theory in the Commission report.

Do higher rate ceilings really increase credit availability, or do they simply boost the profits of finance companies? One would think the Commission would have studied finance company profits in the high ceiling states before recommending that ceilings be increased; however, no such data appears in the Commission's report.

Table V compares finance company profits in six high rate ceiling states with profits in six low ceiling states. The average rate ceiling in the six high ceiling states was 32.36% compared to 27.97% in the lower ceiling states, a difference of 4.39%. After tax profits as a percentage of the average amount of credit outstanding averaged 10.1% in the high ceiling states and 8.1% in the low ceiling states or a difference of 2%. This means that before tax profits were approximately 4% higher in the high ceiling states, assuming a corporate income tax rate of 50%. Practically the entire average increase of 4.39% in the rate ceiling in the high ceiling states went into higher profits for finance companies.

Does this mean that higher rate ceilings inevitably lead to higher profits? Not necessarily. There may be other factors involved to explain higher profits in the high ceiling states. But the figures do give one cause for concern and it is most unfortunate that this matter was not studied more carefully by the Commission.

Aside from dubious statistical evidence, the Commission report also seeks to justify its conclusions in terms of traditional textbook economic theory. According to this theory, an increase in rate ceilings will increase the supply of credit whenever the existing ceiling is below the market rate as determined by the intersection of supply and demand curves. The supply of credit is supposed to increase under a higher rate ceiling for two reasons. First, creditors can afford to extend credit to marginal borrowers who would have been denied credit at the lower rate ceiling. Second, more smaller size loans can be made which could not have been made at lower

Table V

Relationship Between Rate Ceiling and Profits of Finance Companies for Selected States

State	Rate ceiling for a $500 loan	After tax profits as a percent of average loans outstanding
Six Higher Ceiling States		
Florida	34.07%	10.1%
Idaho	33.63%	10.3%
Georgia	33.47%	10.2%
Washington	32.46%	10.7%
Maine	30.47%	9.6%
Minnesota	30.07%	9.9%
Average per State	32.36%	10.1%
Six Lower Ceiling States		
Iowa	28.85%	8.0%
Nebraska	28.80%	7.9%
Nevada	28.64%	7.5%
California	27.58%	8.5%
Illinois	27.33%	8.9%
Missouri	26.64%	7.9%
Average per State	27.97%	8.1%

Source: Kawaja, op. cit.

rate ceilings because of the cost of processing the loan exceeded the revenues from finance charges. The theory assumes that all creditors are perfectly rational, that they correctly perceive the risk and cost involved in making loans, and that they are capable of "fine tuning" their credit policies in response to incremental changes in rate ceilings.

In the real world, it is doubtful that creditors behave in the perfectly rational manner implied by textbook theory. The report itself acknowledges many creditors operate in monopolistic markets where the traditional cannons of economic theory are inoperative. Moreover, credit granting is more of an art than a science. Creditors operate by traditional rules of thumb which are slow to change in response to higher ceilings. An increase of rate ceilings on smaller size loans may encourage more small loans to be made. However, the dollar amount of credit extended may not increase at all as creditors simply substitute more small loans at higher rates for fewer larger loans at lower rates. Consumers would be worse off since they would then be forced to borrow from two or three finance companies at much higher rates instead of from one company at lower rates.

An alternative model to explain how creditors behave in response to incremental changes in the rate ceiling may be more realistic. This alternative model assumes that because of institutional factors and other rigidities, credit granting policies of lenders are largely fixed. An increase in rate ceilings will simply increase a lender's total revenues, and like Parkinson's law, the lender's total costs will rise to absorb the additional revenues. More money will be spent on staff, salaries, travel, advertising, office fixtures and space, convention going and lobbying. Profits may also increase. However, the net amount of credit extended will not appreciably change.

If one had started with this theory of the credit market and spent two years and $1.5 million in collecting data to test its validity, no doubt the theory could be "proven" true just as the Commission report

purports to "prove" the validity of the more traditional textbook theory. Neither theory may perfectly describe reality. The point, however, is that facts and figures do not always speak for themselves. They are determined, to a large extent, by the major assumptions of those who collect them and who have an intellectual vested interest in proving their theories correct.

Will the higher interest rate ceilings recommended by the staff really increase credit availability? Despite all of the esoteric mathematics of the Commission's report and staff studies, the answer is still very uncertain. If we give the Commission report the benefit of every doubt, perhaps the best that can be said in reply to the question is "Maybe, but not very much."

Suppose we give the Commission report the benefit of every doubt and concede there may be some marginal increase in credit availability with higher rate ceilings. Are the staff recommendations for higher rate ceilings then justified? The answer is still no. Contrary to the simplistic approach taken by the Commission report, maximum credit availability is not the only proper goal of public policy. High interest rates are a burden on the budget of the average family and tend to redistribute income from the poor and middle classes to the wealthy. The ready availability of credit also causes some families to overextend themselves by borrowing more than they can really afford.

The Commission report fails to adequately consider these larger social implications. It is one dimensional in assuming that credit is a good thing and that the government should not restrict its availability. It reaches this conclusion through another textbook economic theory—the doctrine of consumer sovereignty. This theory assumes that all consumers are completely rational and are best able to decide for themselves how much credit they need without governmental interference. The report seeks to buttress this position by citing the experience of foreign countries where legal interest rate ceilings are absent.

As in the case of creditor behavior, the textbook economic theories assumed in the Commission report with respect to consumers do not correspond to reality. The wise use of credit can enable many families to finance large installment purchases or to meet unexpected emergencies. But too much credit can lead to financial ruin and bankruptcy. Public policy has always sought to strike a proper balance between maximizing credit availability and promoting the traditional habits of thrift and financial responsibility.

The Commission report uncritically assumes that more credit is desirable. It fails to recognize that credit is essentially a method of forced saving and that there are alternative and less expensive ways for consumers to finance the purchase of goods and services. It would be much cheaper for a family to save the money for a major appliance rather than buying it on time as home economists have been pointing out for years. When a family buys on time it pays much more for the appliance through interest charges, than if it had saved for the purchase. By eroding the traditional habits of thrift and saving, our credit oriented economy threatens to lower the real standard of living of most consumers while increasing still more the income going to the owners of capital.

Given the conflict between immediate consumption and long term saving, what is the optimum amount of credit that is consistent with these competing values? The Commission report argues that consumers themselves should make the decision and dismisses any effort by the government to limit credit availability. It calls these efforts "paternalistic" and an illegitimate attempt by social reformers to impose their values on people who do not accept them. If a low income family wants to borrow $300 to buy a color TV set and is willing to pay 42% interest, the Commission report assumes it should be free to do so without government interference.

What the report fails to recognize is that consumers are not nearly as sovereign as economic textbook theory would have us believe. Low and middle income consumers are constantly pressured by advertising to purchase the goods and services already acquired by the more affluent members of our society. Most consumers are already subject to a brand of paternalism fostered by business enterprise which constantly pressures the public to buy their wares. Unlike other countries, advertising and salesmanship have developed to an unusually high degree in the American economy. Hence the credit policies adopted by other countries are not really relevant to our economy.

The real choice is not between paternalism and no paternalism as the Commission reports assumes. It is between business paternalism that is largely unaccountable to the public and responsible government policies. State governments have traditionally sought to protect consumers from the consequences of their own folly by limiting rates of interest. State small loan laws also require that finance company loans be amortized over a relatively short period of time to insure that borrowers eventually will work themselves out of debt. These requirements also restrict credit availability. More credit would certainly be extended if state laws permitted consumers to borrow small amounts for ten or twenty years. If the only legitimate objective of public policy is to maximize the availability of credit, why shouldn't these amortization requirements be repealed as well?

The Commission report is sadly deficient in considering the social cost of higher interest rates. Despite all the massive data collected by the Commission, one searches

in vain for any study of the impact of higher interest rates on consumers. For example, what is the relationship between high rate ceilings and income distribution? Do high rate ceilings help perpetuate an unequal distribution of income? What impact do high interest rate ceilings have on the rate of consumer bankruptcies? What effect will higher rate ceilings have on saving habits? What are the characteristics of consumers who are denied credit under existing rate ceilings? How many of them really need more credit? What happens to them when they are denied? None of these questions are even addressed, let alone answered in the Commission's report.

The conclusions on interest rates contained in the report are written almost entirely from the perspective of the credit industry. The report assumes that higher interest rates can be justified entirely on the basis of the creditor's cost. Nowhere does the report consider the cost to the consumer. Its narrow scope and limited vision are totally uncharacteristic of a broader perspective one generally associates with a public commission.

SENATOR WILLIAM E. BROCK

CHAPTER 3 - CREDITORS' REMEDIES AND CONTRACT PROVIDIONS

I agree with the conclusion of the Commission that the majority of consumer legislation has been passed with little if any understanding of how such legislation would affect the rate of charge and availability of credit to the consumers. State legislatures would be well advised to look at the Commission's Collection Practices and Creditors' Remedies Survey to ascertain the probable effect the abolition of creditors' remedies will have on rates and availability. I am generally in agreement with the Commission's finding that it is entirely proper for the state legislatures and courts to restrict creditors' remedies which are unreasonable and are likely to cause undue hardships. However, I do not fully agree with the Commission's recommendation that the holder in due course doctrine and waiver of defense clauses be abolished in all consumer credit transactions.

Specifically, I feel that the waiver of defense clauses should be permitted in credit card transactions. The problem here is that we are trying to force the bank-consumer relationship into the same pattern as the bank-dealer relationship. The relationship between the credit-card issuer and the credit cardholder is not the same as that of a consumer and the holder of an instalment loan note made by the consumer. In the first case, the credit cardholder in effect receives a loan from the issuer to make his purchase. In the case of the instalment loan, the holder has bought the paper from the dealer. The positions of the parties are not the same.

Because of the public interest in developing an electronics funds transfer system, we should not burden the credit card transactions with a concept that was developed in and belongs with instalment loan transactions. The nation's economy has been moving toward a "cashless society" where credit cards can generally take over most of the functions performed by cash. Cash is a universal payments mechanism, whose virtue is the absence of any third-party considerations to intervene between the purchaser and the seller (excepting the normal role of banks in the case of payment by check). A "cashless" money system will improve the delivery of purchasing power to all sectors of the economy, will release enormous sums of capital now tied up in the bulky mechanics of each use, storage, and transfer, and has the potential to provide an increasingly effective means of deterring violent economic crimes, among other benefits. Governmental action that intervenes in this process by attaching obligations to the otherwise free and unfettered use of credit cards as a substitute for cash has a potential of retarding the movement of the economy toward a "cashless society".

While I agree with the sentiments against bad merchandising and poor-quality goods that are expressed in the Commission's report, I do not feel that the burden of policing the marketplace should be placed on the issuer of credit cards. The substitution of credit card systems for the use of cash would be impaired since the creditors would have to put self-protecting limitations on the use of the cards as a universal payments medium. In addition, the mechanical difficulty inherent in requiring creditors to police merchants is substantial.

The impact of such a move would undoubtedly fall heavily upon the small businessman. Small merchants more and more are relying on bank credit cards to hold their customers and compete with the large retail firms. We simply cannot ignore the impact that such a move would have on the small business community.

CHAPTER 4 - SUPERVISORY MECHANISMS

The Commission concludes that consumers are entitled to much better enforcement of consumer credit laws than they are now getting. To remedy this, the Commission recommends that Congress as part of the proposed Consumer Protection Agency include a unit to be known as the Bureau of Consumer Credit which will assume the power to issue rules and regulations and supervise examination and enforcement functions of all consumer credit entailed in the Consumer Credit Protection Act, including Truth in Lending. This bureau would also encourage states in their efforts to augment existing staffing and improve existing examination and enforcement procedures. In the event that the proposed Consumer Protection Agency is not created by Congress, the Commission recommends the creation of an independent consumer credit protection agency.

Although I am in complete agreement that consumers are entitled to better enforcement of the existing laws, I do not feel that it would be in the public interest to establish a separate consumer protection agency.

I question this approach as continuing to propose an outmoded solution for an old problem. Some 50 Federal

496-072 O - 73 - 17

agencies and bureaus performing as many as 300 functions have been established to protect the consumer in one way or another. There are in addition numerous state and local agencies performing similar functions. The simplistic solution to each consumer problem has been to establish a new agency.

A far better solution would be to reform and consolidate the existing agencies. This was the thrust of the Ash Council's report to the President in January 1971 on a new regulatory framework. Specifically, it was recommended in that report that new consumer legislation might properly be placed in a reorganized and rejuvenized Federal trade practice agency. Although I recognize that it is not the role of our Commission to make recommendations for an overhaul of the Federal regulatory agencies, I think we could make a significant contribution by recommending an improvement and consolidation of Federal consumer credit protection through a streamlining of the traditional agencies.

CONGRESSWOMAN LEONOR K. SULLIVAN

As the principal sponsor of the legislation which created the National Commission on Consumer Finance, I have had no illusions that a bipartisan group of nine Members with divergent views on regulation of the credit industry—based on extensive participation individually in Federal or state legislative battles on this subject—would or could achieve unanimity on all of the controversial issues this Commission was assigned to investigate. Nevertheless, many far-reaching recommendations have been agreed upon, at least in principle, and the work of the Commission can provide many worthwhile benefits.

But the final Report is an attempt at accommodation of differing views which is only partially successful, and the Report will be useful only to the extent that those who read it and seek to implement it understand the circumstances under which the data was collected and the Report was written.

By the very nature of a national commission composed of six Members of Congress with extremely heavy legislative responsibilities and three private citizens able to devote only limited time to the assignment, the day-to-day workload rested on a small professional staff possessed of special expertise (and the inevitable biases acquired in their own wide experience in economics, law, and other fields). It was the responsibility of the Commission Members to hire the staff director, authorize the employment of specialists and the development of staff studies and outside contracts, review the results, and provide general policy direction. This Commission has suffered from the fact that there have been numerous changes in its membership, although, fortunately, a majority of five of its nine Members has served continuously, including Chairman Millstein, who had to take over the leadership midway through the Commission's work and has performed this assignment with ability, courtesy, tact, and conscientiousness.

Even under the best of circumstances, I am sure we would have had disagreement on some basic conclusions dealing with the question of maximum legal rates on credit charges. Unfortunately, unanticipated delays in the Census Bureau in carrying out the most extensive of the Commission's statistical studies resulted in the submission of great masses of material to the Commission Members, and a necessity for judgments to be made on staff analyses of the data, at a time when four of the six Congressional Members were in the midst of re-election campaigns and all six were deeply involved in major legislative battles in Committee and on the House and Senate Floor in the chaotic homestretch of a two-year Term of Congress.

PROJECTIONS BASED ON DATA STILL TO BE PUBLISHED

Hence, although the Report language was continuously being rewritten down to the deadline to reflect additional data and the comments of individual Members, there was no occasion when all nine Commissioners—or even a majority of five—were able to sit down together and argue out the issues face-to-face once the staff had finally assembled the economic data on which some of the most controversial conclusions of the Report are based—those dealing with maximum rates. In view of the individual dissents from those conclusions, they emerge, therefore, largely as staff recommendations, based on staff studies and econometric projections only four of us serving on the Commission actually had explained to us in detail during nearly three full days of morning, afternoon and evening meetings. Had all nine been present for that extended discussion and debate, I think Chapters 6 and 7 dealing with rates would probably have been cast differently.

When the Report states, as it does in Chapter 7, that state legislators should study the advisability of adopting a rate ceiling structure suggested by the Commission staff as a basis for achieving optimum competition in the extension of loans to low income borrowers, it refers to projections based on data not available to us in final form, which will be published later. Once the data is subjected to the kind of intensive critical analysis it deserves, among a wide spectrum of economists and other consumer credit specialists, we will all have a better basis for judging the validity of these projections. Unfortunately, there was no opportunity to have that kind of public review of the survey information before the Report had to be completed in conformance with the deadline set by the statute under which the Commission operated.

KEEPING THE REPORT IN PERSPECTIVE

The fear has been expressed that instead of being viewed as a package of approaches toward improving the overall operations of the consumer credit market in this country, the Report will be dissected into separate and unrelated segments which will be used to promote the special interest objectives of various pressure groups in the economy. Certainly this can happen if those who shared in the work of the Commission permit such efforts to go unchallenged. The Congressional Members, all serving on the respective House and Senate Committees having jurisdiction over consumer credit legislation and over the functioning of federally chartered or insured financial institutions, are in an excellent position to prevent misuse of Commission data or findings in the achievement of special interest legislative objectives at the Federal level. Furthermore, the state legislatures have demonstrated, under intense pressure of the credit industry in 1969 to pass quickly and without critical analysis the controversial provisions of the proposed Uniform Consumer Credit Code, that they are capable of examining with caution and care issues such as those discussed in this Report, particularly when they recognize that the Commission itself has not endorsed any proposed rate structure as "ideal."

There was basic agreement in the Commission on the value of the Truth in Lending Act in promoting a more informed use of credit by consumers, and there was a desire shared by all of the Members to make this landmark law more effective and more useful through changes in the law and education of consumers in using the law. There was general agreement on the need to stimulate more competition in the marketing of consumer credit. The staff studies and outside research financed by the Commission have provided us with a comprehensive catalogue of the statistics of credit granting in each of the 50 states, not only in terms of comparative amounts and rates but broken down into major categories of consumer credit. This was a monumental task, bringing together information not previously available. For the first time, also, we have a clear picture of how creditors' remedies are used in the various states by different types of creditors in enforcing the repayment of credit arrangements, to enable us the better to judge which techniques are fair and necessary and which are abusive and predatory. Chapter 3 will be particularly useful to the Congress and to the state legislatures in assessing the need for reform in this area.

REPEALING STRONG STATE GARNISHMENT RESTRICTION LAWS

This is certainly not to say that all of the Recommendations of Chapter 3 have been enthusiastically agreed to by all of the Members of the Commission. That is certainly not the case. I personally oppose very strongly the proposal in Chapter 3 which calls upon the states which have much stronger laws than the Federal statute in protecting consumers against garnishment abuses to modify their laws in order to bring them into conformance with the relatively mild provisions of Title III of the Consumer Credit Protection Act. When the Federal Restriction on Garnishment Act was adopted in 1968, it undoubtedly was a strong step forward, in comparison with most of the state laws on this subject at that time; but it was admittedly a compromise intended to win the approval of the Senate Conferees for any Federal law on this subject. Since 1968, and particularly since the garnishment title went into effect on July 1, 1970, many of the states have improved their garnishment laws and brought them at least up to the standard of the Federal law. But I do not think the Federal law is strong enough; nor would it be even with the increase in exemptions proposed in Chapter 3 to 40 times the minimum wage. And I certainly don't think that states like Pennsylvania and Texas, North Carolina and Florida, and others which regulate and restrict garnishment more severely than the Federal law does, should be challenged to repeal—or have superseded by the Federal law—their tougher restrictions on garnishment.

EMPHASIS ON EXPANDING CREDIT FOR HIGH RISK BORROWERS

Which brings me to my basic criticism of this Report, which is that so much of the emphasis is directed toward the expansion of the availability of credit to those who do not now qualify for it because of the fear or probability that they cannot or will not repay. Except for instances of outright discrimination, there was little evidence collected by this Commission to show that *creditworthy* Americans cannot obtain as much credit as they can afford to repay. In fact, the evidence is convincing that large numbers of Americans obtain far more credit than their economic situations would justify. True, they frequently pay a high—a very high—interest rate for this credit. This would seem to indicate that those who extend credit to high risk borrowers are making tremendous profits. But the Commission studies clearly show that the costs of extending credit make it impossible for creditors to extend small loans to high risk borrowers at rates that can possibly be considered "reasonable."

Is the answer, then, to raise all legal ceilings on interest rates to encourage and promote this kind of loan? I think not. As Chapter 8 points out, the ultimate solution for making very low income families eligible for more credit is to enable them to raise their incomes so

that they can afford to repay the credit. But coupled with this sage, if not easy-to-implement, advice is extensive argument in the Report for making it economically feasible, and in fact, quite profitable, for private enterprise to extend cash loans to high risk borrowers through a rate ceiling structure sufficiently high to cover—in all loans—the extra costs of doing business with the high risk borrower. These extra costs result from smaller average loan sizes, increased losses from default, high delinquency experience, and high collection costs, and include, also, provision for a favorable return on investment and borrowed loan funds. To me, this is not a satisfactory solution.

COMPETITION AND RATES

The Commission does urge the removal of existing barriers to competition so that more financial institutions can get into the field of lending money. Commission studies point to a high incidence of concentration in the banking and small loan industries—with comparatively few firms in many states dominating the field of cash consumer credit. Other studies made by the Commission staff, including an econometric model using techniques which those of us who are not economists pretty much have to take on faith, are said to demonstrate that if lenders can charge up to 42% on the first $300 of any loan, with substantially lower rate ceilings on other steps of a loan up to $3,000, this rate structure would be sufficiently high to stimulate competition among lenders for consumer loan business, and thus make more credit available—and hopefully encourage competition in rates, too.

I am not aware of any Member of the Commission who argues that we should call upon the states to set ceilings immediately at 42% on small loans. The wording of the Report is rather fuzzy on that, leading to diverse interpretations by individual Members of the Commission. Essentially, however, the rate structure described, or rather referred to in Chapter 7, is a staff projection. I am not opposed to the Commission releasing the results of staff studies which reflect extensive research authorized by the entire Commission, but on a matter of this kind the staff cannot speak for the Commission.

We have been assured that the raw material which was fed into the computers is the most comprehensive consumer credit information ever amassed for all of the 50 states for a variety of different forms of credit extension. But no computer, and no computerized data, can answer the kind of social and political questions which this Commission, as a Commission, should face, such as:

Do rate ceilings necessarily serve a *bad purpose* when they deny access to credit by those who cannot afford to repay the credit they seek? I don't think so.

Should rate ceilings be set high enough for all consumers so as to make it profitable for creditors to lend money to classes of risks likely to default? I don't think so. Why should good credit risks be subjected, during recurring periods of tight money, to the likelihood of having to pay interest rates geared to the level of return required to enable creditors to lend to bad credit risks?

Should consumers be encouraged to save in advance for major purchases and pay cash when possible? I think so. One of our studies showed that 60% of consumers have that alternative, and many exercise it. Undoubtedly, more who can will do so when they learn through longer experience with Truth in Lending and through education how substantial the savings can be.

THE NECESSITOUS BORROWER

The one new technique suggested in the Report for dealing with the admittedly serious problem of credit availability for the very high risk borrower is the proposal in Chapter 8 for an experimental program of direct loans by a Federal instrumentality, operating as a test in a single city and geared to the special needs of low income borrowers in meeting emergency situations—but under circumstances intended to assure repayment. Such a test program could provide valuable information on the practicability of serving the low income market, and at what rates.

The subsidized low income credit unions so far have had a disappointing experience, according to our information, because of a variety of adverse factors including insufficient training of personnel, but also because, too often, the loans are regarded by many borrowers as being repayable only if convenient. Of course, it is difficult for low income borrowers to repay loans, even when the rate is only 12%. Yet a solution for the availability of credit to people whose needs are suddenly urgent, and whose resources are small, must ultimately lie in a recognition by the necessitous low income borrower that the loan must be repaid if he is again to be able to obtain credit from legitimate sources.

In Title II of the Consumer Credit Protection Act, dealing with loan-sharking, we made it a Federal criminal offense for the illegal loan industry to compel repayment of extortionate loans through violence or threats of violence. Chapter 3 of this Report recommends elimination of many of the abusive legal techniques of collecting debts. Bankruptcy can eliminate the need to repay debts which are clearly excessive. But we are faced still with the problem of achieving voluntary repayments by those now considered high risks but whose needs for emergency loans may be urgent and unpostponable—such as meeting arrearages in rent or mortgage payments to avoid eviction, or to regain possession from a repair

shop of an automobile needed on the job, or to buy work clothing, or achieve the discharge of a hospital patient. The family on welfare can often tap public resources for emergencies; private charitable organizations frequently help, too. But the working low income family often has no source except the loan shark. That is a truly serious problem which the experimental program outlined in Chapter 8 could help solve—or at least show us how, or whether, it *can* be solved.

THE ARKANSAS USURY CEILING OF 10%

Chapters 6 and 7 devote much of their argument to the unavailability of credit in Arkansas where the usury ceiling is only 10%. There is some published evidence that people in Arkansas pay somewhat higher prices for consumer durable goods than those of neighboring or other states where usury ceilings are higher. The Commission itself did not investigate that. And, so far as I know, we have no documentation to show that the *combined* cost of the credit and the retail price on a purchase in Arkansas exceeds the combined price and credit charges for the same goods in states with higher usury ceilings.

The staff studies argue that the people who pay cash in Arkansas are helping to subsidize the cost of extending credit to those who buy on time. The same argument can be made for the department store shopper in any state who pays cash and thereby helps to subsidize the cost of the store's 30-day charge accounts or the discount paid by the store to credit card companies on credit card purchases. The cash buyer, of course, does have the right to ask for a *discount,* too, and can often obtain one; furthermore, under Regulation Z the store can give a cash discount up to 5% without being required to determine its APR as a finance charge. How widespread is this practice in Arkansas?

Before deciding whether to come to the aid of the consumers of Arkansas on the theory that they are being discriminated against by not being permitted to pay more than 10% interest for credit, I would want to know how the *people of Arkansas* felt about it.

THE HEARINGS OF THE COMMISSION

In my opinion, the most useful work performed by the National Commission on Consumer Finance has been the series of hearings conducted by the Commission over a period of several years. The information brought out in the hearings on abusive collection methods and archaic legal remedies available to creditors in compelling the repayment of disputed debts not only contributed to the recommendations in Chapter 3 of the Report but have already stimulated reform in state legislatures of outmoded laws dealing with consumer credit, such as Maine's "debtor's prison" statute.

The hearings on enforcement by Federal and state agencies of the Truth in Lending Act and of state laws dealing with consumer protections in the use of credit formed the basis of the recommendations in Chapter 4 of this Report and also led to increased recognition of the importance of having Federal bank regulatory agencies, with exclusive jurisdiction over the institutions they supervise, examine those institutions for compliance not only with Federal laws but with state laws intended to protect consumers. The "no-man's land" of national bank compliance with state laws, and compliance by federally-chartered savings and loans and credit unions with state laws—institutions which apparently are not subject to inspection and examination by the state authorities—must be brought under effective regulation to show compliance with all laws. The Commission's work in this field has been invaluable.

Another set of hearings, held this year, spotlighted the obsolete practices of many lending institutions and credit grantors in refusing to make credit available to creditworthy women. Our exposure of the problem has helped immeasurably to expedite its correction. This situation is described in Chapter 8.

The survey of consumer credit volume conducted by the Commission through the Census Bureau will, when published, undoubtedly provide extremely valuable data to the credit industry for years to come. So too will the data on the costs of extending credit. To the extent that the Commission has amassed information not previously available in the field of consumer credit, it has performed a useful service and justified its existence. But some of the conclusions drawn from this data are questionable, and as the Member of Congress who initiated the legislation which created the Commission, I disagree with them in whole or in part. Taking up these issues by Chapters:

CHAPTER 3—CREDITORS' REMEDIES AND CONTRACT PROVISIONS

This is an excellent chapter. My reservations deal primarily with *garnishment.* The recommendations on garnishment would effectively insulate workers earning no more than the Federal minimum wage from any garnishment of their wages. I support this. However, for those earnings more than the minimum wage, I believe that at least 90% of their weekly wage should be exempt from garnishment—the figure agreed to by the House in 1968 in passing the Consumer Credit Protection Act. The 75% limitation written into the law by the House-Senate Conference Committee, and endorsed in Chapter 3, was a compromise agreed to by the House

Conferees at the insistence of the Senate Conferees, who had opposed *any* Federal restriction on garnishment. Furthermore, the recommendations in Chapter 3 that states with more restrictive laws on garnishment than the Federal law should modify their laws and bring them into conformance with the Federal statute is contrary to the basic thrust of Title III of the Consumer Credit Protection Act, and I oppose that recommendation. Chapter 3 refers only obliquely to one of the main purposes of Title III of the Consumer Credit Protection Act, (Restriction On Garnishment) which was to discourage *excessive* extensions of credit to workers who are not able to repay the obligations without substantial harm to their family living standards, and who are forced into bankruptcy or made unemployable. The evidence was clear in the hearings which led up to the enactment of the Consumer Credit Protection Act that the existence of the opportunity to garnishee a worker's wages was often the *major factor* in a creditor's decision to extend excessive credit to many marginal risks. A garnishment law which permits no more than 10% of a worker's pay to be taken in satisfaction of debt (as is the case in New York) would still provide a device for collecting from those who refuse to pay just debts while at the same time discouraging the predatory extension of credit to those who cannot handle it without great family hardship.

According to Commission staff studies, as described in Chapter 3, "the availability of credit was substantially curtailed, and the charge for credit was significantly increased" in states where garnishment was either prohibited or restricted beyond the limitations imposed by Title III of the Consumer Credit Protection Act. This may be true in New York, Pennsylvania, Texas, South Carolina, North Carolina and other states which impose restrictions on garnishment tougher than those contained in the Federal law or which prohibit garnishment entirely. But what this data does not show is the *quality* of the credit extended in those states. I completely disagree, therefore, with the suggestion in Chapter 3 that "garnishment be allowed in all states subject to the restrictions" contained in the Consumer Credit Protection Act. I would be less opposed, however, if Title III of the Consumer Credit Protection Act were amended to impose a restriction on garnishment of *no more than 10%* of a worker's pay, rather than 25%, and it applied also to wage assignments.

Furthermore, the proposal in Chapter 3 that employers be prohibited from firing employees regardless of how many garnishments they may sustain requires further study to make sure that employers are not placed in the unhappy situation of being involuntary bill collectors for predators in the consumer credit field. This was one of the situations we were trying to prevent in 1967 in introducing the original version of Title III of the Consumer Credit Protection Act which would have outlawed garnishment entirely.

CHAPTER 4–SUPERVISORY MECHANISMS

The recommendation that all of the *enforcement responsibilities for the Truth in Lending Act* be placed under one agency instead of, as at present, being under nine different Federal agencies having jurisdiction over different categories of credit grantors, would be workable, and would have my support, *only* if we had the assurance that the single agency assigned to this responsibility would have adequate funds to carry out its responsibilities. At the present time, there is no question about the availability of whatever funds are needed by the Federal Reserve Board to carry out its regulatory responsibilities under the Truth in Lending Act and to supervise the enforcement responsibilities of the other eight agencies which share with the Federal Reserve the administrative enforcement of the Act. Some of those eight agencies are not now performing their jobs effectively. But this is not because of lack of funds. The same staff people who enforce other laws for regulated lenders, such as banks, savings and loans, and credit unions, can, at little or no additional expense, examine also for violations by those institutions of the Truth in Lending Act.

The Wage and Hour Division of the Department of Labor which administers the garnishment title of the Consumer Credit Protection Act has had no financial problems in investigating such violations. If funds for an independent regulatory agency are not available, there is no reason why existing agencies cannot continue their present responsibilities as long as there is close surveillance of their performance, either by the Federal Reserve Board which now has that responsibility or by a proposed new Consumer Credit Agency. The Federal Trade Commission has been doing a good job of enforcing the Truth in Lending Act among the vast numbers of businesses over which it has jurisdiction and I would want to be certain that the proposed Consumer Credit Agency would be able to do the job as effectively if the Federal Trade Commission were to be relieved of it.

CHAPTER 5–CREDIT INSURANCE

This Chapter states that the Commission has not had the time or the resources to study credit insurance comprehensively. That is regrettable. It is an important cost of credit. A proper and thorough study should be undertaken by the proposed Consumer Credit Agency recommended by the Commission. As this Chapter

points out, the rates charged for credit life insurance are frequently excessive and should be brought under effective regulation.

CHAPTER 6–RATE CEILINGS

I disagree with some of the conclusions of this Chapter. I certainly do not believe it is "this Commission's view"—certainly it is not my view—that cash borrowers in Pennsylvania and New York would be "significantly better off" if banks were able to charge the same rates for loans as small loan companies. Obviously, many banks in New York and Pennsylvania can make and are making loans at 11.6% APR, as is at least one bank in Washington, D.C., currently advertising a loan of $1,000 at a rate of 11.5% APR. Raising ceilings on rates for *good* risks in order to expand the market for bank loans to higher risk borrowers is not, in my opinion, the solution for the uneven availability for credit.

Furthermore, before I would be prepared to tell the residents of the State of Arkansas that their 10% usury ceiling is unworkable, I would want to know—and we do not have this information—whether credit is available in Arkansas in sufficient quantity for those who are clearly able to repay their loans.

The reference to the APR rates in Hawaii for new car loans as being substantially below the ceiling for such loans does not take into consideration, it seems to me, the fact that U.S.-made automobiles are already priced much higher in Hawaii than they are in the continental United States because of the transportation costs. The average rate for new car loans in Hawaii made by commercial banks during the second quarter of 1971 of 9% APR, compared with a legal rate ceiling of 24.85%, merely suggests, to me, that the ceiling on new car financing in Hawaii is incredibly high and that far fewer new cars would, or could, be sold in Hawaii if a 24.85% rate were charged for new automobile financing in a state where housing costs and other living expenses are extremely high.

The discussion of rates versus ceilings reminds me that after the courts in the District of Columbia ruled that the D.C. banks could not charge more than 8% APR for instalment loans (before that ceiling was raised by Congress to between 11 and 12 percent) some banks in the District of Columbia mounted very extensive advertising campaigns to *attract borrowers at 8%.* Their profit or loss on these loans should have been looked into. Obviously they must have extended loans only to good risks. But what was the actual experience? The Report suffers from the lack of this information.

A theme running through Chapter 6, and through many other sections of the Report, is that since higher rates tend to make more credit available for consumer credit purposes, higher ceilings are therefore a good idea. This is not necessarily so. It ignores the whole picture of credit availability for all purposes—including industrial plants and equipment, housing, consumer loans, automobile credit, small business expansion, government needs, etc. In a period of tight money, unrestricted rates for business credit siphon off vast amounts of money from housing and from other essential purposes. I do not subscribe to the philosophy that we should permit investment funds, willy-nilly, to go to those credit purposes which bring the highest return. Congress in 1969 faced up to this problem by giving to the President and the Federal Reserve Board the power to regulate interest rates and credit terms in any and all types of credit when this is essential to prevent credit inflation and a distortion of the requirements of housing, small business, and other areas of the economy. Consumer credit *is* important to the economy, but it is not the sole concern of those who are responsible for setting credit policy. Even though it is the major responsibility of this Commission, all of us on this Commission are conscious of the fact that a policy for consumer credit cannot be created in a vacuum, insensitive to and insulated from the other credit needs of the economy.

Chapter 6 discusses critically the decisions of some states to impose ceilings on department store revolving credit at less than 18% APR stating that this is not in the best interest of consumers. We have no documentation of our own to support that. Some stores have been offering 3-month (and before Christmas 4-month) credit without service charges in order to promote the sale of goods. This is the basic purpose of retailer credit—just as the advertised specials, parking arrangements, and other services are intended to bring in business and increase sales, whether or not they fully pay for themselves. The retailers who had argued mightily against being required by the Truth in Lending Act to disclose an annual percentage rate for their revolving credit had insisted during Truth in Lending hearings that extending such credit costs them at least 18% of credit sales, citing the same Touche, Ross, Bailey and Smart study referred to in Chapters 6 and 7. I did not take that study seriously during hearings on Truth in Lending in 1967 and I do not do so now as proof that an 18% rate is *required.* It ignores the fact that the credit systems used by retailers are not separate operations intended to pay for themselves any more than do other supportive services of the stores which are adjuncts of selling merchandise. The fact that stores simultaneously offer other credit terms to good customers underscores the weakness of the argument that 18% is sacrosanct.

CHAPTER 7–RATES AND AVAILABILITY OF CREDIT

I have already commented on this Chapter. Some of it is incomprehensible to me. I would feel embarrassed if I thought that all of the other Members of the Commission understood all of the diagrams and technical details better than I do. I consider most of this Chapter a scholarly economic report by highly qualified staff researchers and I accept it as part of the Report only in that context. I think the technical data it contains should have been attached as an appendix to the Report, and identified as a staff study, rather than being presented as part of the Commission's findings since I doubt that any of the Members of the Commission would endorse it completely as their own views.

Several of the Members of the Commission, in separate views, have expressed the fear that the rate structure referred to in this Chapter as a so-called ideal to achieve the "optimum availability of credit" will be seized upon by credit industry lobbyists to pressure such ceiling rates through the legislatures while the pro-consumer features of the Report are ignored. Certainly, we all have an obligation to make sure this does *not* happen. The proposed rate structure does not represent a consensus of the views of the Commission Members.

The Commission generally agreed on the expansion of competition in consumer credit as a principal objective. Furthermore, once the research material on which this Chapter is based is made available to the economics profession, it can stimulate discussion and evaluation of the factors used by our staff enconometricians in developing the kind of rate ceiling structure they feel would promote more competition among credit grantors. This material will also encourage further study of the advisability of making more credit available to low income, high risk borrowers. But in the meantime, I certainly have no intention of endorsing, or passively accepting, any rate ceiling structure recommended to the states which would set no interest rate ceiling on loans under $100 and let rates on $300 loans go up to as much as 42%. Although the 42% rate ceiling on $300 loans is not specifically cited in Chapter 7 it emerged from the econometric model on which much of Chapter 7 is based. I think most of us on the Commission are fearful that when this data is published, it will be taken as reflecting the *Commission's* views that a 42% ceiling is justified in order to make credit available to low income borrowers and promote competiton. Hence, it should be stressed that the Commission itself has never voted for such a rate schedule and does not endorse it.

CHAPTER 8–SPECIAL PROBLEMS OF UNAVAILABILITY

The "small-small" loans in Texas at rates in excess of 100% are cited approvingly in Chapter 7 and also in this Chapter. The figures show that 10% of the loans are written off as bad debts. Yet, even so, the return on loan company investment after taxes is more than 10%, despite the high loss ratio. Obviously, extending such credit is costly and requires a high rate. The question is whether such credit serves a useful purpose or merely victimizes those who are encouraged to borrow at such fantastic rates of interest. The fact that people "come back for more" does not establish the validity of these loans as a matter of public policy. Do these people ever get out of debt or do they spend their lives borrowing to pay off maturing obligations?

CHAPTER 9–FEDERAL CHARTERING

The legislation creating the Commission expressly called upon it to "include treatment" of "the desirability of Federal chartering of consumer finance companies. . .". Chapter 9 presents a series of pro and con arguments which are useful for discussion purposes and may stimulate public interest in this idea. I have no strong feelings on this issue on way or the other. However, I do not believe the main thrust for such a program should be for the purpose of enabling the federally chartered institutions to ignore state usury laws.

CHAPTER 10–DISCLOSURE

There was no evidence presented to the Commission, that I am aware of, to indicate that present requirements of the Truth in Lending Act on the *advertising of credit terms* are too stringent or are impractical. While it is true that credit advertising virtually stopped after the Act went into effect, it began to revive as creditors discovered the value of advertising their credit terms honestly and fully, and not deceptively. Many automobile dealers, second mortgage lenders, banks and other types of creditors are now advertising their installment terms, giving all of the essential facts, including the down payment required and total cost including finance charge. Chapter 10 proposes eliminating those two requirements. I think that would be a disservice to consumers shopping for the best credit terms. Similarly, the proposal for eliminating the necessity of including certain critical features of open end credit arrangements

when advertising what purport to be the terms, while simplifying space problems for merchants and credit card companies in soliciting new accounts, could very well mislead consumers into signing up for open end accounts with disadvantageous terms. I disagree completely with these recommendations.

I have difficulty with another recommendation in this Chapter that sellers' "points" in real estate transactions should be counted in all instances into the annual percentage rate of the finance charge on the assumption that the seller's points are automatically incorporated into the selling price of the house. Both FHA and VA are committed by law and regulations against permitting seller's points to be added to the appraised value of the house and, although we know that this prohibition is often violated through lax appraisal practices or subterfuges of various kinds, I would be reluctant to legitimize the practice by amending the Truth in Lending Act on the assumption that it is *always* happening. Of course, when there is evidence that the seller's points are indeed included in the sales price, they should be figured into the APR.

Chapter 10 skims only in passing over one of the assignments given to this Commission in the Conference Report on the legislation which became the Consumer Credit Protection Act—that is, determining the consequences to effective disclosure under Truth in Lending of exemption from annual percentage rate disclosure of minimum monthly charges of 50 cents on open end credit and finance charges of $7.50 or less on closed end transactions of $75 or more. Chapter 10 assumes these were wise decisions by Congress in writing the law. The House Conferees had *opposed* exemption of minimum charges from annual rate disclosure, but reluctantly compromised with the Senate Conferees on the point, specifying that the issue should be studied by this Commission. The Commission, to my knowledge, has developed no information to justify such exemptions, merely citing the generalization that the exemptions simplify computations for small business firms. The exemptions definitely obscure the comparative costs of such credit as measured by the APR, particularly on installment contracts. We have not really studied this issue in any depth.

CHAPTER 11—EDUCATION

This Chapter attacks the basic problem of consumer unawareness of interest rates, finance charges, and the costs of using credit in an uniformed manner. Truth in Lending disclosures are of little value to those who pay no attention to the information disclosed. Much more serious are the consequences to the unwary debtor of signing a credit contract he does not understand. While the recommendations in Chapter 3 dealing with creditors' remedies will go far towards eliminating abusive practices which frequently victimize consumers entering into consumer credit transactions, the ultimate solution for the hardships experienced by uninformed consumers in contracting debts under terms and conditions they do not understand (and which they are often not in a position to discharge) is to make information about credit not only *available* to consumers but *understandable* and *important* to them. This Chapter sets out a variety of approaches to that objective. This Commission has financed extensive research into how much or how little the average consumer using credit knows or remembers about the terms he agreed to, and it is clear that, three-and-a-half years after the initiation of Truth in Lending, we still have an appalling amount of ignorance on this matter, particularly among young, low income individuals with less than a high school education.

CHAPTER 12—THE FUTURE OF CONSUMER CREDIT

The expected emergence of a "checkless-cashless" society through an electronics funds transfer system scares many consumers, and with good reason. The computer may be ready to take over a multitude of consumer transaction accounting chores, but the public is not yet ready for the computer! The cancelled check, and a copy of the voucher that the consumer signed in entering into a credit transaction, are still, in the customer's mind, his main and perhaps only effective defense against recurring computer errors and the resulting frustrations, annoyances and threats.

Taming the computer—or at least training adequately the human beings who operate computers and those who initiate the harassments which result from computer errors—is an absolute must or the credit industry will lose more in customer good will than it can ever gain in accounting efficiency. Of all of the letters received by Members of Congress from constituents on consumer credit issues, complaints about billing errors in computerized systems—and the inability to straighten them out—are by far the most voluminous.

The existence of the Fair Credit Reporting Act of 1970 has gone far toward alleviating the worst fear of consumers about billing errors—the concern that their credit rating will be damaged because of a creditor's error. But as present trends in consumer credit clearly forecast, and as Chapter 12 points out, credit decisions will become increasingly less personal and more automated, and it is essential that the Fair Credit Reporting Act be strengthened to meet these challenges. Experience under this Act since it took effect in April 1971, points up the necessity to provide—as the House

Conferees on this bill had proposed—clear-cut authority to the Federal Trade Commission to issue compliance regulations which would have the force and effect of law, just as the Federal Reserve Board has authority to issue binding regulations under the Truth in Lending Act.

The Commission did not go into the deficiencies of the Fair Credit Reporting Act which limit its effectiveness as a "Good Name" Protection Act. The 93rd Congress should do so.

A SUMMING UP—CHAPTER 1

In an attempt to summarize the work of the Commission, Chapter 1—the last Chapter to be written and one which has been subjected to numerous revisions down to the final deadline—implies that the consumer credit industry has done a remarkable job of serving the American people despite inordinate interference and "tinkering" by government. There is no question that the industry has grown tremendously since World War II and has made possible a great expansion in consumer purchases and improvements in living standards for most Americans.

But the role of Government—Federal, state and local—in regulating this industry is of vital importance in maintaining not only its integrity but its health and growth and stability. The so-called "tinkering" has by no means been all negative: the existence of consumer credit stems primarily from our monetary system which makes available, through governmental decisions, and often through government loan funds, the money which *finances* credit.

The differing state laws on the regulation of consumer credit provide us with a laboratory for testing out various approaches to effective regulation in the public interest. The work of this Commission has resulted in the testing of many of those approaches from the standpoint of credit availability, competition, and overall effectiveness.

The staff of the Commission, under Executive Director Robert L. Meade, has developed voluminous research material which will be of great assistance to the states and to the Federal Government in determining future policy on credit regulation. Once this mountain of data is published in usable form, and is subjected to the kind of critical study on a wide scale which it deserves, those of us who dissent from the staff recommendations on rate structures may eventually feel that we were wrong or hasty in our judgments. Only time and thorough analysis of the data will determine that. But, on the basis of the limited time which we have had in which to try to understand the complex material obtained during the course of the staff's extensive investigations, surveys and econometric projections—information which has been developed in the final months of this Commission's existence and is still in the process of being organized—we have not been persuaded that the facts justify many of the conclusions expressed. That is certainly the situation as far as I personally am concerned.

Commissions have the power only to recommend laws, not to enact them. Therefore, there is time for Congress and the Executive Department, and for the state legislatures, to study this Commission's proposals in depth before attempting to write laws based on them.

Hence, consumerists who specialize in economic theory and consumer law must be just as active as the credit industry's consultants and experts in studying the Commission's technical reports and making their voices heard on the facts as they see them. The legislatures will certainly need this kind of consumer assistance, and so will the Congress, in making the ultimate decisions on new consumer credit laws.

CONGRESSMAN HENRY B. GONZALEZ

It is regrettable that after so much work and discussion the Commission was not able to give close attention to the final shaping of its Report. Largely this was because the completion of the Commission's work coincided with the ending of the 92nd Congress and the beginning of a period of heavy political campaign activity—a circumstance which prevented the Congressional members from devoting much attention to the important problem of determining its exact recommendations. Because of this, many members including myself disagree with a number of conclusions drawn by the staff. In fact, the very inability of the Commission to find an opportunity to closely examine the draft report means that a great many of our findings and recommendations are actually those of the staff rather than the Commission itself, even though they are invariably written as, "This Commission finds. . ."

It would be an exercise in futility for me to try and list all the statements in this Report with which I disagree, either wholly or in part. Much of what is said is valuable and I have no quarrel with. Yet I would be remiss if I failed to enumerate at least a few major findings I cannot accept, much less subscribe to.

First, I do not believe that the Commission should endorse the principle of allowing wage garnishment for failure to repay loans. Garnishment is specifically forbidden in the constitution of my state, and there is no evidence that Texas lenders need this weapon to use against delinquents. Indeed, Texas probably has the biggest, most aggressive, and unquestionably the most diverse consumer loan industry in the country. Texas small lenders probably underwrite the biggest number of very high risk small loans in the nation, and they write off perhaps ten per cent of these loans—more than half of which are for less than $100—and still make annual profits of at least 11% net. The lack of garnishment certainly has not inhibited lenders from doing business in my state, has not kept them from entering aggressively into very high risk loans, and has not harmed their profit picture at all.

Second, the Commission Report recommends that those states having low interest rate ceilings should revise those ceilings to allow much higher interest rates to be charged on consumer loans. It is argued that this would make credit more readily avilable—undoubtedly so, because it would greatly increase the profit protential of the consumer credit business in those states. The Report also says that people need to have more access to "legal" loans so that they can avoid loan sharks. But I have seen no evidence to show that loan sharking is a big problem in states that discourage high interest loans, nor that the people of those states are demanding that high interest loans be more readily available to them. In fact, in Texas, where the consumer loan industry has very high allowable interest ceilings, the public demand is just the opposite—to reduce interest rates and discourage the high pressure salesmanship that so frequently accompanies legalized high interest rates. I have the distinct impression that the higher the interest rates, the more aggressive the lender is, to the point of taking imprudent risks himself, and certainly inducing his customers to do likewise.

For example, the Commission knows full well that a lender will not hesitate to make a risky loan on an automobile, for it can readily be repossessed and sold. More often than not, the sale does not cover the outstanding debt, and the debtor ends up owing the balance due plus the charges arising from the sale itself. The lender emerges with his money intact, the debtor winds up with no car and in debt for several hundred dollars, at a high interest rate. If the lender did not have such ready assurance of a profit whether or not the loan is good, he would not be so anxious to "sell" loans that he well knows are a disservice to his client.

Yet in the face of this, the Commission would endorse both high interest rates and wage garnishment. The Texas experience should show plainly enough that the lender who has high interest rates available hardly needs anything else to assure making a handsome profit.

Third, consumers have enough problems in obtaining minimal protection already, especially at the state level. Federal legislation in behalf of consumers hardly sets a shining example, and we should be reluctant to encourage repeal of state policies which may seem quaint to academicians, but which have served well and do not seem to have greatly discouraged the growth of consumer credit.

The Commission has done much valuable work. The staff studies include many original and valuable efforts, and will be a rich source of information on consumer finance for years to come. Yet I am not prepared to wholly endorse this Report and have many more exceptions than can be recorded here. I do not feel that the Commission would have approved a great many recommendations that bear its imprimatur, had it been possible for its members to find time to more thoroughly review and discuss them.

DR. ROBERT W. JOHNSON

I have read the separate statement of Senator Proxmire and appreciate and share his concern for the low income consumer. I am equally concerned, however, that maintenance of present rate ceilings and market structures will not promote the welfare of this segment of society, but will actually be adverse to their interests.

Senator Proxmire's objection to the rate ceilings examined—but not proposed—by the NCCF are predicated on the assumption that increased rates will not benefit consumers. He asserts that, even if higher rate ceilings *did* increase the availability of credit, the "Commission's report fails to adequately consider the undue burden which higher interest rates will place upon consumers." This is a central issue that overshadows even the charge that "the Commission's research has not demonstrated with clear and convincing evidence that higher interest rate ceilings will substantially increase the availability of credit." He questions the effectiveness of markets for consumer goods and services in this country and whether consumers can be "trusted" to make their own choices among the goods and services offered in these markets. Because of the fundamental issues raised by such questions, I will deal with first his "undue burden" argument and then with the adequacy of the staff study showing the relation of credit availability to the price of credit.

1. The Social Cost Issue

The Senator's assertion that higher ceilings on the price of credit will place an undue burden upon consumers rests upon three basic premises:

1. If higher rate ceilings are provided, rates actually charged in the market will move significantly higher than at present.
2. Higher rate ceilings will permit, if not encourage, consumers to overtax themselves and to assume excessive debts.
3. Low rate ceilings are needed to protect consumers from their own folly.

Let me examine each of these charges with care, since they are the basic supports to his argument that higher ceilings on the price of credit will place an undue burden upon consumers.

Rate charged will not move to the rate ceilings

Senator Proxmire asserts that: "[a]n increase in rate ceilings will simply increase a lender's total revenues. . ." and suggests that banks, finance companies, and retailers can reasonably be expected to raise their finance charges by five percentage points on all but automobile credit. No econometric techniques are needed to question the validity of such estimates. The analysis in Chapter 6 of the Commission report demonstrates clearly that even in the present somewhat imperfect market rates do not rise to the ceilings. For example, the Senator alleges that, given higher rate ceilings, commercial banks can be expected to increase their charges on personal loans by five percentage points (Table 11). But Exhibit 6-2 of the Commission report demonstrates that even in states *without any rate ceiling* the rates charged by commercial banks on personal loans ($1,000, 12-month loans) are no higher on average than in other states that limit the rates banks may charge to a range of 14 percent to 16 percent. In view of this evidence how can he justify an assertion that higher rate ceilings will cause banks to increase their rates by an average of five percentage points—that is, from a U.S. median of 14.45 percent to 19.45 percent? In the seven states with no rate ceiling, the average rate charged is the *same* as the national median—14.45 percent. The spectre raised of a $3.5 billion increase in finance charges is thus directly contradicted by the evidence in Chapter 6 that led to the agreed conclusion: "If the legal rate ceiling is set above the market rate, the market rate prevails, and average rates of charge do not rise to the ceiling."

I would like to think that one of the main reasons that prices of consumer credit do not rise to rate ceilings is the competitive shopping fostered by Truth in Lending. In the Senator's own words quoted in Chapter 10:

> The main thrust of the Truth in Lending bill is to promote more effective price competition in the consumer credit industry. As you know, competition is the essence of our free enterprise system. The workings of the competitive market insures that

consumers will be able to obtain the kinds of goods they want at the lowest possible price.[1]

Although the Commission has observed some lack of enforcement of Truth in Lending and has recommended some minor changes, it still appears to be effective legislation in encouraging competition to force prices of most consumer credit transactions below established price ceilings.

Higher rate ceilings will not cause families to become overburdened

Senator Proximire suggests that it may not be in the best interests of American consumers to increase the availability of credit to them, because this "also causes some families to overextend themselves by borrowing more than they can really afford". Some low income families may overextend themselves if more cash credit is made available than now provided under prevailing rate ceilings. But those misfortunes must be weighed against the substantial benefits that most other families could achieve by having legal cash credit available as an alternative to their existing sources of credit. When low rate ceilings restrict availability of credit, low income consumers turn to disreputable merchants where the cash price of goods may be excessive or to the illegal loan market where the rates and collection methods are truly oppressive.

Moreover, the Senator's argument is cast entirely in a context of cash credit. The data provided the Commission in the study by Brandt and Day show clearly that low income minority consumers are heavily dependent upon retail dealers for credit and often find cash credit inaccessible (Chapter 6). For example, there are no consumer finance companies in the District of Columbia. But if low income consumers obtain most of their credit from credit retailers, rate ceilings provide no check upon their obtaining more credit "than they can *really* afford." Many credit retailers make no overt charge for credit, but this apparent generosity hardly prevents low income families from becoming overindebted.

A major implication of the staff study is that if legal cash credit were made available to low income consumers, they would have a viable alternative to loan sharks and the avaricious credit retailers. The present cost to low income families of shoddy merchandise and oppressive collection methods is difficult to translate into a numerical figure, but contemporary values would appear to compel the conclusion that it is too great. A concern for low income consumers should lead to a desire to foster more competition in their credit markets, rather than to accede to the present high level of costs that they actually incur.

Even if rate ceilings did restrain consumers' use of credit, it is doubtful that the government should undertake the role of deciding how much credit consumers should have. The doctrine of consumer sovereignty does not assume, as the Senator suggests, that "all consumers are completely rational and are best able to decide for themselves how much credit they need. . ." It does, however, suggest that the magnitude of errors made by each consumer acting in his own behalf is likely to be less than the distortions imposed by other consumers who seek through the government to impose upon the rest of us consumers their value judgments concerning the appropriate use of consumer credit.

Rate ceilings do not protect consumers "from the consequences of their own folly."

Senator Proxmire states that state governments "have traditionally sought to protect consumers from the consequences of their own folly by limiting rates of interest." Again, this argument appears to be set in a context of cash credit only and overlooks the ineffectiveness of rate ceilings on sales credit. A low income family may acquire a color TV set through a credit retailer without paying any overt finance charge. How does a rate ceiling prevent this alleged folly?

But the ineffectiveness of rate ceilings in "protecting" consumers is secondary to a more fundamental issue. The members of this Commission are not willing to assume that the desires of high-risk and low income consumers to acquire the goods and services enjoyed by others in society is folly. The color TV set adverted to by the Senator as a possibly unnecessary expenditure for the low income consumer may indeed be the cheapest form of entertainment or education for the family. While this is a decision that must ultimately be made by the states, the Commission considered it a vital part of its mandate to point out the rates at which these markets may be served by legitimate credit grantors.

The Senator is correct in pointing out that consumers are pressured by business enterprise to buy its wares. Massive advertising campaigns are undertaken to secure both consumers' dollars and their votes. If that advertising is false or misleading, that should be the focus of attack. It is better to eliminate misleading advertising than to attempt to limit the ability of consumers to respond.

Attached hereto and incorporated herein are two memoranda from staff economists dealing with technical aspects of Senator Proxmire's separate views.

---

[1] *American Banker*, December 20, 1967, p. 91.

NATIONAL COMMISSION ON CONSUMER FINANCE
1016 - 16TH STREET, N.W.
WASHINGTON, D.C. 20036

December 12, 1972

MEMORANDUM

TO: Robert L. Meade
FROM: Douglas F. Greer

I have several problems with Senator Proxmire's separate views, three of which I cover here.

In my opinion Senator Proxmire's statement is misleading in view of research findings both in our Commission studies and in the academic literature.

1. As to Senator Proxmire's charge that selected states were used to prove a point; this was simply not the case. The summary tables of finance company extensions for high and low ceiling states, Exhibits 7-12A and 12-B shown in Chapter 7 of the Commission's Report, were included solely to illustrate the findings of the econometric analysis and not for purposes of proof. For this limited purpose, the tables are not misleading because in an array of all 48 states included in the analysis from highest to lowest mean rate ceiling the top quartile of states have an average of $63.99 extended per family and .066 loans extended per family compared with averages of $49.69 and .050 for the bottom quartile of states. Moreover, the simple correlations between mean rate ceilings and per family extensions is positive and significant at the 5 percent level.

2. The data presented in Senator Proxmire's statement, based on data drawn from Michael Kawaja's *Regulation of the Consumer Finance Industry* are misleading. The statement uses Kawaja's data to support the claim that profits are high in high ceiling states and low in low ceiling states. But on page 85 of the Kawaja study, in a table entitled "Regulation and Earnings," Kawaja presents a regression estimate of the relationship between profit and his measure of rate ceilings which shows absolutely no association across states between these two variables. Moreover, the Commission's staff has conducted a profit margin analysis which is consistent with Kawaja's finding. (See Greer, "An Econometric Analysis of the Personal Loan Market.") Similarly, Table 5 on page 69 of the Kawaja study contains two equation estimates which show that reserves for bad debts (losses) as a percentage of average loans outstanding is a positive function of Kawaja's rate ceiling measure, and the relationship is significant at the 5 percent level. Further confirmation of the positive relationship between rates and losses is provided by Maurice Goudzwaard ("Price Ceilings and Credit Rationing," *Journal of Finance*, March 1968) who found the same strong association using similar data.

3. Finally, Senator Proxmire's statement selects only one equation from the many equations estimated by the staff for finance company personal loans as being representative of the effect of rate ceilings on credit availability. That equation included observations from all states, but for obvious theoretical reasons a more relevant equation would have been one which included only those states where rate ceilings were in fact the primary determinant of the observed market rates that is, the states with relatively low rate ceilings. For the 24 states included in the analysis with average ceilings below the median for all 48 states, the estimated elasticity of dollar supply with respect to rate ceiling is +.88 and for numbers supply it is +1.32. Thus, a 50 percent rise in rate ceilings for these states, which are the ones most affected by low ceilings, would increase the credit supplied by about 50 percent or more. Furthermore, rate ceilings and finance company growth together account for more than 60 percent of all supply variations in these 24 low ceiling states. Despite these findings which were given to Senator Proxmire's office, the Proximire statement relies again on the Kawaja study for evidence concerning rates and availability. However, the citation in the Kawaja study is quite misleading in this regard. Not only is Kawaja's regression analysis misspecified in this respect, but more importantly,

because of data deficiencies, it excludes from consideration 9 of the 24 states included in the staff's analysis of low ceiling states. In short, it is difficult to draw proper conclusions about the impact of low rate ceilings on availability unless one looks at the availability situation in states where rate ceilings are indeed low.

Although this memorandum is not a comprehensive analysis of my problems with Senator Proxmire's statement, these are three points that I wanted to bring to your attention.

NATIONAL COMMISSION ON CONSUMER FINANCE
1016 - 16TH STREET, N.W.
WASHINGTON, D.C. 20036

MEMORANDUM December 5, 1972

TO: Robert L. Meade

FROM: Robert P. Shay

SUBJECT: Senator Proxmire's rate ceiling statement

There are three aspects of Senator Proxmire's statement on rate ceilings which should be called to his attention.

First, there is no staff recommendation of a rate ceiling structure now included in the report. At the meeting at Airlie House, the Commissioners decided that they could not endorse any specific rate structure and particularly one which included a 42% rate on loans of $300 or less. In my staff study, I shall compare the estimated costs of making loans of $300 or less with the rate structure proposed by the UCCC and conclude that few such loans will be made at the UCCC 36% APR rate ceiling as the estimated costs run from 39% APR for a loan of $300, to 53% APR for a loan of $200, to 91% APR for a loan of $100. Only then will I point out that states willing to establish a rate ceiling of 42% for loans of $300 or less can expect loans to be made, and such loans will be in the $275 to $300 range. If states are to attempt to meet the smaller loans demanded by people of very limited circumstances they will have to embark on a subsidy program or else adopt special rate provisions, as is now done in eight states, for such borrowers. For loan sizes ranging from $150 or less in South Carolina; loans of $100 or less in Mississippi, Oklahoma, and Texas; loans of $95 or less in North Carolina; $90 or less in Montana; $75 or less in Alabama; to $50 or less in Alaska; all such statutes allow rate ceilings ranging by size of loan from 61% to 240% APR.

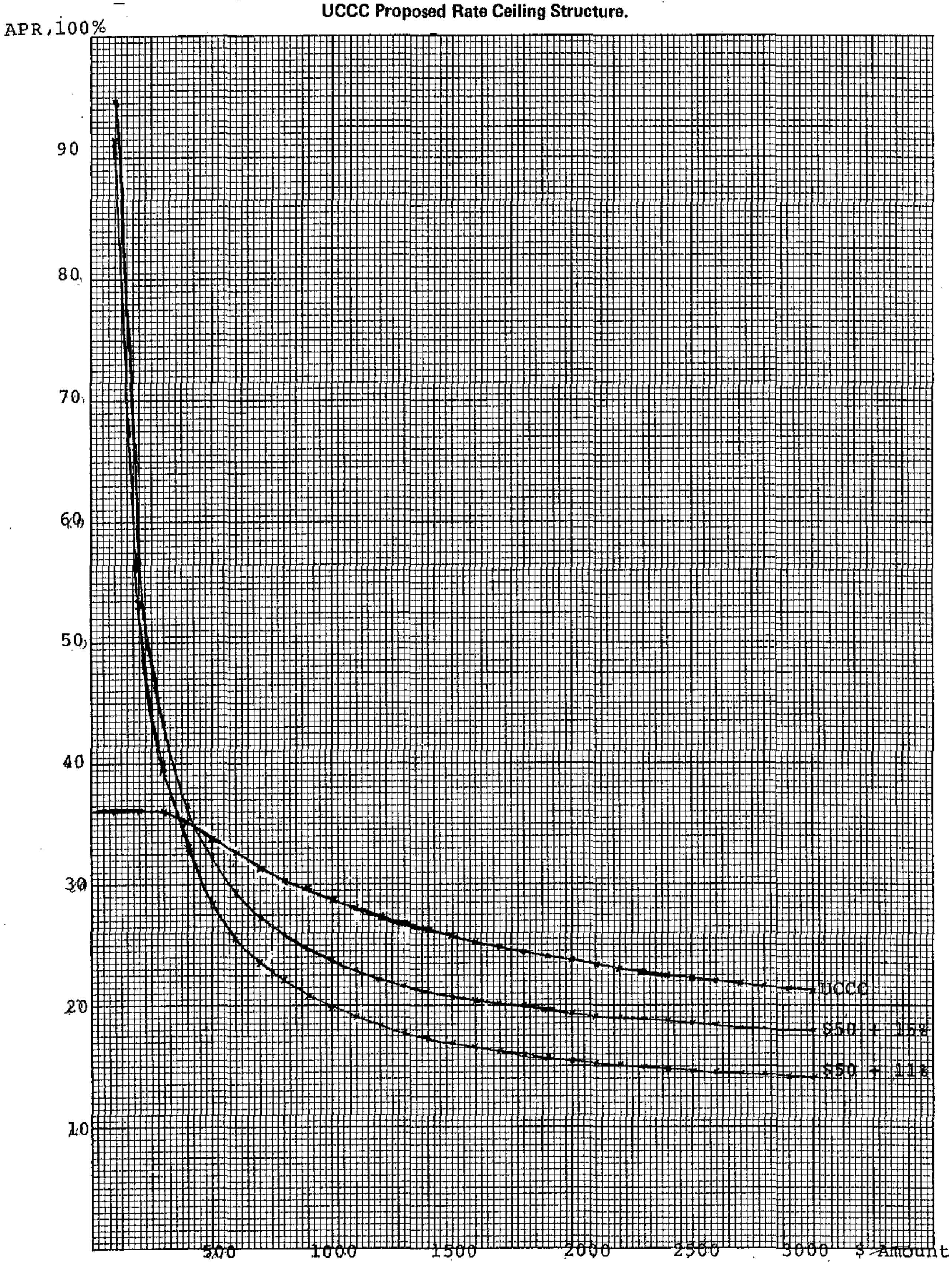
Senator Proxmire will have to choose between supporting the notion that these borrowers would be better off without credit, should be subsidized, or should be allowed to borrow legally under close supervision at very high rates of charge. My staff study will suggest that below $100 loan size, an unconscionability standard applied to licensed and closely supervised lenders would better serve the borrowing public than making all such rates legal. On loans above that size, the two estimates of the required costs for making loans shown in Exhibit 7-18 in Chapter 7 of the final report will give the states and Senator Proxmire our most conservative estimate of what APR is needed if the rate ceiling is to be realistic—that is, if one expects profit-oriented lenders to make such loans. Finally, I shall demonstrate that attention should not be focused upon the highest rate ceiling in any proposed rate ceiling structure—for it is not at that point where consumers are charged rates which are truly excessive.

For example, look at Figure 1 where the proposed rate ceiling structure of the Uniform Consumer Credit Code (UCCC) is compared with our schedule of APR's required to cover costs of granting loans in $100 intervals up to $3,000. Up to $300, as noted earlier, the UCCC rate ceiling is below both estimates of the required costs of making such loans. At $400, the UCCC rate ceiling is intermediate between the two estimates of cost, being above the estimates associated with the risk characteristics of borrowers presently being served by the finance industry, but still below the estimates provided for a higher average level of credit risk than that currently assumed (mid-1971). At $500 and above, the UCCC rate ceiling is substantially higher, although its designers were careful to keep the rate ceiling structure sloped downward in reasonable relation to our estimates of required costs. The point at which the UCCC rate ceiling is farthest above the cost estimates for the lower risk category is the $1200 loan size (the $1300 loan size for the other risk category). If I were convinced that the competitive assumptions of the UCCC were incorrect and that interest rates actually charged would rise to the rate ceiling, I would say that the UCCC resulted in these $1200-$1300 borrowers being overcharged the most. In short, it is the rates at 27½% or 28%, *not 36%*, which might be called too high.

486-072 O - 73 - 18

FIGURE 1

APR's Required to Recover Total Estimated Costs by Size of Loan Compared to UCCC Proposed Rate Ceiling Structure.



The second aspect of Senator Proxmire's rate ceiling statement which he should reconsider are his two statements underlying his disbelief "that higher interest rate ceilings (in some states) will increase the availability of credit to consumers and particularly to marginal credit risks." For example, he notes that "the Commission's research has not demonstrated with clear and convincing evidence that higher interest rate ceilings will substantially increase the availability of credit." What he really means, which is a quite different thing, is that he hasn't reviewed the staff evidence because, the staff report on interest rates was not available for review at the time comments were due. While there is still time, I am enclosing the statistical evidence from my staff study on interest rate ceilings for his review. They will at least provide him with an opportunity to avoid having to base his disagreement with the staff's findings on other than substantive grounds.

Tables 1 through 6 show the relationships between rate ceilings and market concentration to the amount and rates of charge for new automobile credit, other consumer goods credit (financing goods other than automobiles, mobile homes, and boats, aircraft and recreational vehicles), and personal loans. The tables support the following conclusions:

New automobile credit (Tables 1 and 1A)

A. Rate ceilings – The basic finding is that the total number of new auto loans is reduced (increased) by 4 loans per 10,000 families when the rate ceiling on retail new auto credit sales (Indirect RC) is reduced (increased) by one percentage point (1.00%). It might be noted that the effect is not large, as the mean number of new auto loans per 10,000 families was 312. Furthermore, there is no significant difference in the average APR among the states when the rate ceiling is raised or lowered. The rate ceiling on direct new auto loans from banks was not significantly related to the number of loans or APR for new auto credit and is not listed for that reason.

When we examine the two components of the new auto credit market, we note that the significant rate ceiling effect is confined to the purchased paper portion of the market (Table 1A). In that segment differences in rate ceilings are directly related to the number of loans and to the rate received by the agency purchasing the paper (BAPR). Thus, it is possible to say that a percentage point reduction (increase) in the indirect rate ceiling will be associated on average with 1.5 fewer (more) loans per 10,000 families. (The mean number of indirect new auto loans per 10,000 families was 152). The buying rate for paper on average will be .014 lower (higher) but there is no significant difference in the average APR paid by the customer.

This evidence supports the contention that the raising or lowering of rate ceilings in the new auto credit market affects availability without any discernible effect upon interest charges.

B. Concentration and other variables – It is of interest to note that increases (decreases) in concentration ratios within limited and statewide branching states (CR-LB and CR-SB) are associated with higher (lower) average APR's charged for new auto credit in those states than in unit banking states. There is no significant relation to the amount of credit granted. There are, however, significant differences in both the APR and the dollar amount of credit associated with the commercial bank concentration ratio in the direct loan portion of the market. The other variables listed in the equations should be regarded here as only to standardize for differences among the states in other factors affecting the demand or supply for new auto instalment credit. They will, of course be examined in greater detail in other staff studies.

Other consumer goods credit (Tables 2 and 2A)

A. Rate ceilings – For the market as a whole, there is no significant association between the levels of rate ceilings and either the dollar amount of credit granted or the average APR among the states. There is, however, an indication that the average APR is affected within the finance company portion of the market (Table 2A). This is probably why a coefficient appears in the APR column for all credit sources (Table 2), which is not strong enough to reach the 95% confidence level. Within the finance company component of the market, there is also a coefficient which indicates an availability effect in the expected direction but

Table 1

Rate Ceilings and Market Concentration Ratios Related to the Amount of New Auto Credit and to the Average Annual Percentage Rate

Independent Variables	Total Credit		Commercial Bank Direct Loans	
	#Loans**	APR	#Loans**	APR
Constant	57.83	8.47	29.89	6.29
Indirect RC	0.41*			
CR - direct Bk			-0.068*	0.0073*
CR - LB	-0.11	0.019*		
CR - SB	-0.08	0.015*		
CB - indirect MR		0.012		
CB - indirect CHI				0.28*
% Age 20-45	0.67			
GRP	1.70	0.16*		
TDI - CB		0.35*		0.36*
y_4 - 10			0.17*	
AVS	-0.01		-0.0066	
NADSQ	0.005*			
RMI	-26.32			1.90*
DMO				0.90*
R_2 (unadj.)	44%	75%	26%	59%
(adj.)	29%	72%	20%	54%

* $P \leq .05$

** Per 1,000 families, 2nd quarter 1971

N = 39 states

Table 1A

Rate Ceilings and Market Concentration Ratios Related to the Amount of New Auto Credit and to the Average Annual Percentage Rate

Independent Variables	Indirect Credit			
	#Contracts**	APR	DAPR	BAPR
Constant	-4.01	2.60	-3.13	6.41
Indirect RC	0.15*			0.014*
CR-indirect Bk & Fin.	0.054	0.011*	0.008	
CB-direct MR		0.37*		0.39*
% Age 20-45	0.45	0.17*	0.044	
LA	0.84*			
SDUM				-0.23*
TDI - CB	-1.03		0.173	
Gross Markup			0.077	
DMO	5.29*	-0.97*	-1.16*	
NADSQ				0.00015*
RMI			2.24*	-1.11*
R^2 (unadj.) (adj.)	49% 41%	59% 55%	64% 59%	65% 61%

* P ≤ .05
** Per 1,000 families, 2nd quarter 1971
N = 39 states

Table 2

Rate Ceilings and Market Concentration Related to the Average Annual Percentage Rate and to the Amount of other Consumer Goods Credit From Selected Credit Sources

Independent Variables	All Sources		Retailers	
	\$ Amount[a]	APR	\$ Amount[a]	APR
Constant	-22.95	9.81	7.87	2.60
RC		-0.034	0.22	
CR_F		-0.046*		
CR_B			-0.44*	
RRR	-0.55*	0.54*		
RRRD				1.18*
CLA	2.06*	-0.25*	1.52	-0.22
GRP	3.08	-0.56*		-0.63
WAR_{CB}		-1.00*	4.56	-0.79
WAP_{CB}				-1.06
BCCRD	-1.50*		-0.90	-0.23
BCCR				0.70
GR	10.02*		7.22	2.60*
TEEN	4.45*		4.27*	
LNPLE			11.92	
y_4 - 10			-0.73*	
DQ_{CB}			-2.22	-0.94
SB			-9.95*	-1.77
LB			-9.70*	-1.74
ACP			-2.26	0.45
R^2 (unadj.)	75%	69%	80%	57%
(adj.)	73%	64%	72%	44%

* $P \leq .05$
N = 42 states
a = per family

Table 2A

Rate Ceilings and Market Concentration Related to the Average Annual Percentage Rate and to the Amount of other Consumer Goods Credit From Selected Credit Sources

Independent Variables	Commercial Banks		Finance Companies	
	\$ Amount [a]	APR	\$ Amount	APR
Constant	8.07	-2.77	-9.86	0.71
RC			0.076	0.17*
CR_F			-0.11*	
RRR				0.41
RRRD	-1.31*			0.74
WAR_{CB}	-1.94*	-0.93*		1.12
WAP_{CB}	-2.30*		1.65*	
GR		1.37*		-0.94*
LB				-0.81
SB			3.85*	-1.13
ACP				0.33*
y_4 - 10	0.22*		0.28*	-0.06
TDI_{CB}	-0.97			
BCCRD			0.43*	
DQ_{CB}			-1.80*	
CLA	-0.28	-0.37*	0.55*	
LREV		0.68	2.97*	
WBE		0.004*		
GRP				-0.29
LNPLE		2.25		
R^2 (unadj.)	41%	58%	65%	78%
(adj.)	33%	52%	57%	72%

*P .05
N = 42 states

a = per family

which is not acceptable at the 95% confidence level. These results may be interpreted to mean that an increase (decrease) in rate ceiling of one percentage point was accompanied by an average increase (decrease) in APR's paid by customers of finance companies of .17%, but without a significant alteration of the dollar amount of credit granted. There were, however, no significant differences in APR or dollar amounts of credit granted by commercial banks and retailers attributable to rate ceiling differences. The market as a whole, it follows, was not visibly affected by rate ceilings. One reason for the significant rate response among finance companies to a percentage point difference in rate ceiling is that the median size of credit contract financed among the state averages was $334 under a median rate ceiling of 21% APR. Finance companies do not regard such paper as profitable, but it is purchased by some independent companies as a feeder for their personal loans which can be made at higher rates. On the other hand, the major finance companies involved in the purchase of other consumer goods paper are subsidiaries of major manufacturers who can derive their profitability from the prices of goods as well as from the finance charge revenue.

B. Concentration ratios and other variables – The negative association of concentration ratios among finance companies with the average APR paid for credit among all credit sources is puzzling, especially since there is also a significant negative association with the dollar amount of credit granted but not with the average APR in the finance company portion of the market (Table 2A). But the interpretation of the competitive implications of these data is best left to Douglas Greer's staff study.

Personal loans (Tables 3 through 6)

Rate ceilings, market concentration, and rejection rates are so interdependent in the finance company sector of the personal loan market that their separate relationships to the average APR and dollar amounts of credit cannot be ascertained. In short, finance company rate ceilings are negatively correlated with finance company concentration ratios (R=–.48) and with rejection ratios (R=–.38) at statistically significant levels. Furthermore, finance company concentration ratios and rejection rates are positively correlated (.35). These correlations suggest that the variables are not truly independent and do not satisfy the assumption of independence required for their use in regression analysis. This lack of independence will have to be kept in mind in analyzing the data in subsequent tables. The simple fact is that when rate ceilings are lower (higher), finance company personal loan markets are more (less) concentrated, and rejection rates are higher (lower). There is only a moderate correlation (–.18) between the weighted average rate ceiling and the weighted average concentration ratio in the personal loan market when all credit sources are combined because there is little or no correlation between rate ceilings and concentration ratios for commercial banks and credit unions.

In the personal loan market as a whole (Table 3), when the finance company average rate ceiling rises by 1.0%, the average APR rises by .32% and the average number of loans from all sources is estimated to rise by 18 per 10,000 families. The mean number of loans per 10,000 families is 1,286. The dollar amount of loans granted appears to be higher but the result does not attain the ninety-five percent confidence level. Average concentration ratios, on the other hand, are negatively related to the number of loans but positively related to the dollar amount of loans. This result suggests that after the influence of other variables has been taken into account, that with higher (lower) average concentration ratios in a state, fewer (more) loans are granted in larger (smaller) amounts. Rejection ratios of finance companies are also significantly related to the dollar amount of credit and the average APR as well. But since some intercorrelation remains among the "independent" variables, the size of the coefficients must be viewed with caution. When the concentration ratios for banks and finance companies are included separately in the right hand panel of the table, the rate ceiling coefficients remain significant. Our major conclusion from Table 3, then is that when the finance company rate ceiling is higher (lower), the average APR in the personal loan market will be higher (lower) by about one-third of the rise (fall) in the rate ceiling, and the number of loans granted will rise (fall) significantly. It is likely that the size of loans made will be somewhat smaller (larger) on average so that the amount of loans may not be appreciably more (less).

Table 3

Rate Ceilings and Market Concentration Ratios
Related to the Number and Amount of Personal
Loans from All Credit Sources and to the
Average Annual Percentage Rate

Independent Variables	Weighted Avg. Concentration Ratio			Separate Concentration Ratios		
	# of Loans [a]	$ of Loans [b]	APR	# of Loans [a]	$ of Loans [b]	APR
Constant	-411.13	-344.34	-7.33	-298.07	-287.79	3.46
RC_F	1.80*	1.10	0.32*	1.68*	0.76	0.20*
CR_{AS}	-1.39*	0.75*	0.034	#	#	#
CR_B	#	#	#	-0.22		0.026
CR_F	#	#	#	-0.97*		-0.099*
RR_F		-0.43*	-0.073*		-0.45*	
$SLOP_F$			0.86			0.26
ACP	10.45*	9.53*	0.81*	7.45*	8.96*	0.39
CLA	4.61*	4.78*	-0.30	5.05*	5.50*	
GRP		-4.94		-4.55		
Y4-10	2.65*	1.21*	0.15*	2.01*	1.03*	0.14*
GP		10.64	1.48			1.68
WAP_{CB}			1.60	-19.03*		
WAR_{CB}	-20.18*			-24.53*		
%UPL		0.44*	-0.069*		0.38*	-0.05*
RMI			-7.71			
1/LSL		-8510.75*	834.54		-8630.27*	937.93*
WAG	36.45*	24.95*		54.20*	17.13	-1.42
R^2 (unadj.)	62%	76%	61%	72%	72%	69%
(adj.)	56%	69%	49%	53%	55%	61%

*$P \leq .05$

Specifically deleted

N = 47 states

a = per 1,000 families
b = per family

Turning now to the finance company portion of the market, it is desirable to recall the rate ceiling hypothesis suggested by economic theory and summarized in Chapter 7. In imperfect markets with a wide range of legal rate ceilings, we would expect that as rate ceilings rose toward the competitive rate level (P_c), the average APR among the states could be expected to be higher and the amount of credit be larger. As rate ceilings rise beyond the competitive rate, monopoly elements would force rates still higher but a higher rate beyond the competitive level would force the amount of credit to be less. Thus, in a regression including all states we would expect to find a significant coefficient relating the rate to the average APR but not to the amount of credit unless the average APR's in the predominance of states were heavily either above or below the competitive rate level. Table 4 confirms this hypothesis. The rate effect is significant while both the number and dollar amounts of credit granted are as predicted. The appearance of the negative coefficient for the number of loans suggests that there may be a predominance of rates which are higher, rather than lower, than the competitive rate level, but it is not good practice to speculate on possibilities. It should be noted that both concentration ratios and rejection ratios were not in the equation, purposely, so that the relation cannot be attributed solely to a rate ceiling effect but to the combined rate ceiling-concentration-rejection effect which can be expected to occur over a long-enough time period after rate ceilings are raised or lowered.

In the middle panel of Table 4, we note that when rate ceilings and rejections are deleted from the equation, higher concentration ratios are negatively related to the average APR, the number of loans, and the dollar amount of loans granted. With rate ceilings such an important influence on the price of credit in the finance company sector, Douglas Greer and I have hypothesized that market power is exerted in a non-traditional manner in this industry. Our hypothesis is that market power is used to increase profits by rejecting borrowers who might entail higher collection costs and default losses. Since, unlike public utilities, finance companies have the right to choose their customers they can limit their costs and probably losses by excluding riskier applicants. This line of reasoning is only partly confirmed by the significant APR coefficient in the right-hand panel of Table 4. Further evidence will be viewed in the Greer study.

To further test for the restrictive rate ceiling effect upon the number and amount of personal loans, a functional form was chosen to fit the hypothesis that the number and amount of loans could be expected to rise and then fall with higher rate ceilings. The equation $Y = a + bX + bX^2$, where Y is the number of loans and X is the rate ceiling along with other variables is shown in Table 5 for two groups of states. First, the 23 states with the lowest rate ceilings were chosen because rate ceiling effects could be expected to be strongest in that group. Then, the remaining 24 states were subjected to a similar test. Finally, the test was applied to all 47 states. The rate ceiling variables were significant in the lower rate ceiling states and among all 47 states. As might have been expected, they were not significant among the higher rate ceiling states since, at some point, rate ceilings will rise beyond the point of profit maximization for firms with market power where they will have no further influence upon the market.

To find that rate ceiling which maximizes Y, it is necessary to solve for that value of $X = \frac{-b}{2c}$ (see proof below). Dividing the rate ceiling regression coefficient for the number of loans (8.61) by 2 times the regression coefficient for the squared rate ceiling gives a value of 26.9% indicating that the number of loans is highest at that average rate ceiling. The calculation applied to the regression coefficients when the dollar amount of loans is the dependent variable yields a rate ceiling of approximately the same average value, or 26.8%. Thus, we conclude that when the small loan rate ceiling, on average, approaches 27%, the availability of personal loans from finance companies is highest, under mid-1971 rate ceilings and other conditioning market factors.

Among commercial banks, rate ceilings did not appear to significantly affect either the number or dollar amount of personal loans granted. However, a most interesting rate ceiling relationship to the APR was ascertained by searching among the low ceiling states for a non-linear relationship similar to that found among the states in the finance company segment. Among the 23 states with the lowest rate ceilings there was only the linear rate ceiling significant regression coefficient, suggesting that among the lower half of states ranked by rate ceilings, there would be higher APR's associated with higher rate ceilings and no

Table 4

Rate Ceilings, Market Concentration and Rejection Rates
Related to the Number and Amount of Finance Company
Personal Loans and to the Average Annual Percentage Rate

Independent Variables	# of Loans a	$ of Loans b	APR	# of Loans a	$ of Loans b	APR	# of Loans a	$ of Loans b	APR
Constant	+71.07	-170.86	-9.96	-232.80	-152.20	22.98	-257.58	-177.96	15.04
RC_F	- 0.75		0.46*	#	#	#	#	#	#
CR_F	#	#	#	-0.67*	-0.398*	-0.19*	#	#	#
RR_F	#	#	#	#	#	#		-0.32	-0.17*
$SLOP_F$									1.35
UEM	6.20		0.78*			0.75*			1.90*
y_4 - 10		0.57	0.19*	1.23*	0.74*	0.15	1.29*	0.53	0.17
GR			2.14			3.38*			2.61
WAP	-13.54					-2.94*			
WAR	- 6.92		-2.01*			2.98*	-5.86		2.23*
CVR_F	71.06*		10.82*	38.76*		9.45*	48.89*		13.49*
CVR_{CB}						9.74			
C + A_{MOD}	- 0.53	11.77*						12.44*	
MSBD	-17.80	15.27*				2.21	-13.66	-12.59*	
LSL	18404.45 *			13828.27*			15071.18*		
1/GFC	-11.12*	- 4.19*					-6.25*		
AGE		6.33*		8.08*	6.06*		8.08*	6.96*	
UPL_F		0.12							
SDUM									-4.60*
TDI_{CB}			1.75*						
R_2 (unadj.) (adj.)	53% 43%	57% 52%	76% 72%	67% 64%	51% 49%	69% 62%	65% 60%	55% 51%	65% 59%

* $P \leq .05$

Specifically deleted

N = 47 states

a = per 1,000 families
b = per family

Table 5

Curvilinear Relationship of Legal Rate Ceiling to the Number and Amount of Finance Company Personal Loans and to the Average Annual Percentage Rate

Independent Variables	23 States With Rate Ceilings Below 27%			All 47 States		
	# of Loans [a]	$ of Loans [b]	APR	# of Loans [a]	$ of Loans [b]	APR
Constant	-196.09	-179.49	-23.65	-26.80	2.58	-18.05
RC_F	24.22*	25.51*	2.76	8.61*	5.90*	1.12*
RCSQ	- 0.55*	- 0.61	-0.054	- 0.16*	-0.11*	-0.012
MSBD	- 22.80*	- 19.19*		- 5.55	-7.66	
$SLOP_F$	- 4.20	- 0.93	1.45	- 3.14	-2.30	-0.22
WAP_F	- 7.62	- 7.91		-17.05	-7.89	
WAR_F		1.19	-1.69	-11.73	-4.98	-1.74*
CVR_F	48.15	- 6.60	11.38*	72.31*	19.20	10.94*
$1/LSL_F$	18891.97	2226.40	-1000.91	15871.92*	-1262.42	
1/GFC	- 30.26	- 33.64	-2.80	-67.29*	-43.70*	
$C + A_{MOD}$		7.28	3.33	11.15	11.26	-0.45
UEM			1.10			0.74*
TDI_{CB}			0.096			1.67*
y4 - 10			0.14			0.19*
GR			1.31			2.13
R_2 (unadj.)	75%	71%	93%	59%	39%	78%
(adj.)	63%	51%	84%	49%	24%	73%

*P ≤ 0.05

a = per 1,000 families

b = per family

apparent difference, as noted, in the number or dollar amount of loans. As nine more lower rate ceiling states were added to the 23 states, there began to be signs that the APR was leveling off or turning down, as the rate ceiling coefficient lost significance and the RC^2 coefficient became significant. When all states were included, both the RC and the RC^2 coefficients became significant. The latter result in the right hand column of Table 6 suggests that as rate ceilings rise, average APR's rise up to some point, beyond which they decline. Utilizing the same calculation noted above, but this time to find that rate ceiling which maximized the APR, it was estimated to be 23.5% on average. Since there were no commercial bank rate ceilings this high, it is obvious that the no ceiling states which were assigned an arbitrary value of 25% rate ceilings, were responsible for the lower APR's which made the regression curvilinear and turn down at rate ceilings (supposedly) above 23½%. This result lends support to those who hypothesize focal pricing in consumer instalment credit: that is, the existence of a rate ceiling above customary rates of charge in an imperfectly competitive market allows banks, in this instance, to charge higher rates than would otherwise be the case because the existence of a still higher rate ceiling presumably acts to justify the higher APR. With no rate ceiling at all, the hypothesis is that rates would be lower. In any event, the empirical result dictates caution in raising rate ceilings in the range of rate ceilings which currently exist in the 23 states with the lowest rate ceilings.

These, then, complete the empirical tests of the relation between rate ceilings and the availability of credit in the new auto, the other consumer goods, and personal loan markets. Rate ceilings were found to be significantly related to both availability and price (APR) in the personal loan market, to availability only in the new auto credit market, and to neither availability nor price (APR) in the other consumer goods market. In both the new auto and personal loan markets, the rate ceilings which appeared to affect the availability of credit were the higher of the rate ceilings which existed in each market. Under the assumption (to be discussed further below) that rates of charge are directly related to the degree of credit risk among borrowers, there is the implication that decreased credit availability falls upon those whose credit standing is weakest—those financing new autos through dealers and customers receiving personal loans from finance companies.

Because elements of market power were found to be present in all three markets, the recommendations that the states raise or lower rate ceilings to increase the availability of credit were given a lower priority than the need to promote the competitiveness of consumer credit markets. Thus, the removal of barriers to entry and restrictive rate ceilings was recommended to allow lower cost creditors to compete for higher cost borrowers. At the same time, efforts to stimulate competition must provide sufficiently low market concentration to ensure that lower cost borrowers (particularly among commercial banks) will not be charged the higher rates charged higher risk borrowers. In such instances, it would appear desirable, at least temporarily, to retain the lower commercial bank rate ceilings in those states where concentration ratios indicate a problem of market power and allow entrance of banks into the finance company market, as the report recommends, by establishing a separate licensed department of the bank whose record keeping, examination procedures and other operational aspects be kept separate from the bank's instalment loan department in order to qualify for licensing and supervision typically given finance companies by state officials. Further, the entrance of savings and loan associations and mutual savings banks could accentuate competitive pressures and assure that lower cost borrowers would receive rates of charge commensurate with their lower credit risk.

Finally, Senator Proxmire quite correctly argues that states should not be "selected" to prove points. In preparing the Commission Report, the technique of using selected states was chosen to illustrate results previously ascertained by econometric equations. We did not select the states to prove our hypothesis.

On the other hand, Senator Proxmire's statement devotes four pages of typescript and three tables (III, IV, and V) to present "selected" states with higher and lower rate ceilings from data in the Kawaja study appendix to try to establish doubt that the *assumptions* underlying recommendations concerning finance companies in the analysis in the Commission Report are incorrect or subject to doubt.

Table 6

Rate Ceilings and Market Concentration Related
to the Number and Amount of Commercial Bank Personal Loans and to
the Average Annual Percentage Rate

Dependent Variables	23 States with Rate Ceilings below 13%			32 States with Rate Ceilings below 16%			47 States		
	# of Loans[a]	$ of Loans[b]	APR	# of Loans[a]	$ of Loans[b]	APR	# of Loans[a]	$ of Loans[b]	APR
Constant	-40.81	-93.34	8.48	112.69	74.86	24.12	-60.33	-40.53	1.57
RC_{CB}		2.56	0.32*	-19.95	-15.78	-2.30	- 0.45	2.56	1.13*
RCSQ				0.76	0.69	0.11 *	0.02	-0.05	-0.024*
CRCB	-0.19*		0.022*	0.049	0.17*	0.022*		0.10	0.006
CRFC			0.034*	-0.15		-0.028*			-0.013
Δ LA	3.16*	2.09*		3.75*	3.71*		3.91*	4.27*	
GRP		2.70					-2.26		
LB	14.12*	11.61*	0.71*	10.20*	11.08*	0.58*	10.05*	8.26*	0.22
MSBD		19.83*			13.08			13.09*	
LSL	-0.00064		0.00006*	0.00049		0.00005	0.00127*		0.00004
Y4-10	0.29		-0.023	0.96*	0.42		1.07*		0.44
GCB	17.06*	31.23*	0.88				13.25		
GFC	3.60	5.25	-1.12*		3.48	-0.42		4.15	
GP	16.90*	26.11*			10.57	1.54*		6.77	-0.77
GR			1.01*	7.45		0.90*	12.24*		
WAP	-12.71*	-12.90*		-10.87*	-5.69	0.60*		-4.89	
WAR	- 7.19*			- 9.19			- 8.41*	-4.44	
CJP	12.23*				-5.70				0.51
R^2 (unadj)	91%	90%	92%	62%	71%	89%	62%	63%	75%
(adj)	85%	83%	87%	44%	57%	85%	54%	54%	70%

* $P \leq .05$

a = per 1,000 families
b = per family

The assumptions questioned were the following:

1) credit availability will rise with higher rate ceilings (Table III)

2) bad debt reserves will be higher as rate ceilings rise (Table IV)

Finally, Senator Proxmire criticizes the lack of attention to finance company after tax profits and states to "prove" that their profits are higher in higher rate ceiling states than in lower rate ceiling (Table V)

In all three cases, it is not clear whether Senator Proxmire is illustrating the fallacious technique he c or whether he believes that he has used a fallacious technique to "prove" his own hypotheses. In event, it should be noted that Kawaja's study* and the Chapman-Shay study* of the Consumer F industry established the following points concerning the assumptions:

1) Kawaja found a significant *positive* relationship between the average rate and the number o and a significant negative relationship between average rate and the dollar amount of loans. Kawaja's findings generally support Senator Proxmire's hypothesis with respect to the amount of loans only.

2) Kawaja found "a significantly positive relationship between risk, as measured here, and rate. Kawaja's Chart 7 and Equations 5-5 and 5-6). This finding refutes Senator Proxmire's hypo

3) In the Chapman-Shay study (page 105), the following finding concerning finance co profitability is relevant:

   "The conclusion to be drawn from these data with respect to operating profitability is tha loan licensees appear to be able to adjust expense and income ratios by regulating their a loan sizes and risks assumed according to the opportunities presented under sta regulation .... Operating profits result from income-expense relationships which, between appear to be related to the degree of risk assumed, and the number of offices in relation population."

Operating profits, then, were found to be unrelated to rates. Both of these studies utilized corr analysis to establish these findings. The Kawaja finding with regard to availability in relation to rate c was superseded by the results of our more detailed studies in Tables 4 & 5, as attached.

Senator Proxmire is critical of the use of econometric studies which only account for some portion variation to be explained. The fact that 68% of the variation was explained in a cross-section study be regarded as an achievement, not a liability. Further, he mentions the "rate of unemployment, n family income, wage rates of employees in finance companies, the degree of economic concentration finance company industry, and the growth rate of finance companies."

Each of these variables was tested and some of them account for part of the explained variatio symbols for each of the variables in the attached tables 1-6 are:

Unemployment rate - UER
Std. deviation of unemployment rate - SDUM
Economic concentration:
- All credit sources - CR_{as}
- Finance companies - CR_F
- Banks - CR_B
- Retailers - CR_R

---

*Michael Kawaja, *Regulation of the Consumer Finance Industry*, Columbia University Press, 1971; and John M. Ch and Robert P. Shay, *The Consumer Finance Industry: Its Costs and Regulation*, Columbia University Press, 1967.

Wage rates - SAL
Growth rates (inverse) - GFC, (1/GFC)
Real Family Income - RMI

When these variables are not listed, they were not strong enough to meet the standard set for their inclusion. Thus, they cannot be important. But, as may be noted, some were.

In view of the conclusions in the revised Commission report and the evidence to be presented in the staff study, The Impact of Rate Ceilings Upon the Availability and Price of Credit, it is evident that much of Senator Proxmire's statement should be reconsidered.

Proof for maximizing variable Y

$$Y = a + bx + cX^2$$

$$\frac{dy}{dx} = 0 = b + 2cX^*$$

$$X^* = -\frac{b}{2c}$$

Note: X* is the rate ceiling value which maximizes Y.

ADDITIONAL SEPARATE VIEWS OF SEN. WILLIAM PROXMIRE

The separate views of Professor Johnson are a criticism, not of the Commission report, but of my separate views concerning the report. Since chapter six and chapter seven of the report apparently reflect Professor Johnson's own views, he is thus afforded a second opportunity to argue his case. It is only fair and proper that I be given a similar opportunity to respond to Professor Johnson's allegations and those of the staff published with his views, particularly since these allegations contain several misleading and inaccurate descriptions of my separate views.

As an example of Professor Johnson's misleading description of my views, consider his statement on page 2 where he states that "Senator Proxmire asserts that '[a] n increase in rate ceilings will simply increase a lender's total revenues. . .' (p. 18)". Taken out of context, this quote implies that I made a positive assertion that higher rate ceilings simply increase a lender's total revenues and nothing more. However, a complete reading of my views on p. 18 makes it clear that I made no such positive assertion. Instead, I *suggested* an alternative hypothesis to explain creditor behavior and I acknowledged that neither this alternative theory nor the Commission theory may perfectly describe reality. The central thrust of my views was to criticize the Commission for failing to examine alternative theories for explaining a creditor's response to higher rate ceilings and for relying exclusively upon the traditional economic textbook theory.

Professor Johnson also criticizes my estimate that interest paid by consumers will rise by $3.5 billion if the staff's recommended rate ceilings are adopted. However, Professor Johnson presents no estimate of his own. If he really believes that rates will not increase, then what is the point of raising interest rate ceilings? The basic argument of chapter seven is that higher rate ceilings will increase credit availability by permitting creditors to charge higher interest rates. Professor Johnson cannot have it both ways. He cannot argue that higher rate ceilings are needed and then deny there will be no increase in interest rates.

Professor Johnson fails to say that I acknowledged that my estimate of a $3.5 billion increase in interest rates "is undoubtedly subject to further refinement." If he thinks $3.5 billion is too high, then what is a proper estimate? Once again, he misses the central point of my criticism and that was that the Commission staff itself should have prepared such an estimate for the Commission before recommending higher interest rate ceilings. How can legislators intelligently determine public policy unless they have some estimates of the cost?

Professor Johnson also criticizes my argument that it may not be in the best interests of American consumers to increase the availability of credit since such an increase may lead to an over-extension of credit. Professor Johnson states that "*Some* low-income families may overextend themselves if more cash credit is made available. But those misfortunes must be weighed against the substantial benefits that *most* other families could achieve by having legal cash credit available as an alternative to their existing sources of credit." [emphasis supplied]

Professor Johnson has merely echoed the conventional arguments made by creditors without any empirical data to support his conclusions. Where is the evidence in the Commission study to justify the notion that higher interest rate ceilings would only have an adverse effect on *some* families, but would benefit *most* families? Most of the data compiled by the Commission came from the credit industry. There were no surveys conducted to find out what consumers thought about higher interest rate ceilings. If Professor Johnson is correct that higher rate ceilings are in the best interests of consumers, it is somewhat surprising that consumer groups have not championed higher rate ceilings.

Finally, Professor Johnson argues that rate ceilings have proven to be ineffectual in protecting consumers, since some retail merchants can always conceal the cost of credit in their cash prices. While there may be some circumvention of interest rate ceilings through this device, a merchant does not have complete freedom to charge whatever price he wants. His prices must be reasonably competitive with other retailers or he runs the risk of losing sales or having his prices subject to legal challenge under the doctrine of unconscionability. In any event, the fact that some unscrupulous merchants have circumvented interest rate ceilings does not argue for their complete abandonment in all consumer credit markets.

I will not comment at length on the staff views appended to Professor Johnson's remarks other than to note that Professor Shay's memorandum dated Dec. 5, 1972 is directed at an earlier version of my views which has since been revised. For example, Professor

496-072 O - 73 - 19

Shay points out that there is no staff recommendation in the Commission report for higher interest rate ceilings. My statement of views was revised to reflect this fact after a statement was included in the transmittal letter to the report which made it clear that the Commission has not approved the higher interest rate ceilings recommended by the staff.

Professor Greer's memo argues that my criticism of the Commission report's methodology is misleading. Specifically, he argues that it is not true that the report selected data from eight high ceiling states and eight low ceiling states to prove a point—that higher rate ceilings increase credit availability. Instead, Professor Greer maintains the 16 States were selected "solely to illustrate the findings of the econometric analysis and not for purposes of proof". However, as I have shown in my separate views, it is possible to select 16 other states to illustrate an opposite argument—namely, that rate ceilings have no effect on availability. I agree with Professor Greer that the experience in a limited number of States doesn't prove anything. Neither does it "illustrate" anything.

Professor Greer's disclaimer aside, the average reader, untrained in econometrics, will take the data from the selected 16-State sample in chapter 7 as constituting proof of the theory in the Commission report that higher rate ceilings will increase credit availability. Accordingly, it is the Commission report itself, and not my individual views, which are misleading.

Finally, Professor Greer argues that it is not proper to rely upon the staff's econometric equations derived from data from 48 States. He argues that when one divides these 48 States into two groups of 24 States, there is a more pronounced relationship between rate ceilings and availability in the 24 low ceiling States and very little relationship in the 24 high ceiling States. If this is true, it would seem to follow that rate ceilings in at least 24 States can be safely reduced without substantially affecting credit availability. And yet the staff has recommended rate ceilings which exceed the legal ceilings in all 50 States. Professor Greer's comments thus seem to be at variance with other staff recommendations and support my arguments that a rate ceiling of 42% on loans under $300 is too high.

COMMISSION HEARINGS

AND

WITNESSES

COMMISSION HEARINGS

Methods of Debt Collection
New Senate Office Building
June 22 - 23, 1970

Witnesses

Charles Baron
Chief of Law Reform
Community Legal Services
Philadelphia, Pa.

David Caplovitz
Professor of Sociology
Columbia University
New York, N.Y.

Paul Garrity
Professor of Law
Boston College Law School
Boston, Mass.

Richard A. Givens
Assistant U.S. Attorney
New York, N.Y.

Maribeth Halloran
Attorney
Neighborhood Legal Services
Washington, D.C.

Edna DeCoursey Johnson
Director, Family Services Program
National Urban League
Washington, D.C.

Hon. Mary Gardiner Jones
Commissioner
Federal Trade Commission
Washington, D.C.

Benny Kass
Attorney
D.C. Commission on Interest Rates
Washington, D.C.

Judson Miner
Attorney
Chicago Council of Lawyers
Chicago, Ill.

Ralph Nader
Center for Study of Responsive Law
Washington, D.C.

Michael Padnos
Director
Legal Aid Society
Atlanta, Ga.

Hon. Morton Perry
Judge, Small Claims Court
Miami, Fla.

Hon. William Proxmire
U.S. Senate

Howard T. Reben
Attorney
Pine Tree Legal Assistance
Portland, Me.

Philip Schuchman
Professor of Law
University of Connecticut
Storrs, Connecticut

Ralph Stone
Chief of Law Consumer Unit
Legal Aid Society
St. Louis, Mo.

William Willier
Director, and
Blair C. Shick
Attorney
National Consumer Law Center
Boston, Mass.

Consumer Credit Protection Laws: Whose Responsibility?
Rayburn House Office Building
June 22 - 23, 1971

Witnesses

Florence Bernstein
Attorney
Los Angeles, Calif.

Dr. George Benston
Professor of Economics
University of Rochester
Rochester, N.Y.

Elmer W. Campbell
Bank Commissioner
Philip R. Gingrow
Division of Personal and Consumer Finance
State of Maine
Augusta, Me.

Dr. David I. Fand
Professor of Economics
Wayne State University
Detroit, Mich.

Hon. J. Deanne Gannon
Deputy Administrator
Fred Haden
General Counsel
National Credit Union Administration
Washington, D.C.

James E. Hagen
Bank Commissioner
Patsy J. Piscopo
Deputy Commissioner
Larry Portell
Director, Consumer Credit Division
Edward Dooley
Asst. Director of Bank Examination
State of Connecticut
Hartford, Conn.

Hon. Miles W. Kirkpatrick
Chairman
Robert Pitofsky
Director, Bureau of Consumer Protection
Sheldon Feldman
Acting Asst. Director, Special Projects
Federal Trade Commission
Washington, D.C.

Freyda P. Koplow
Commissioner of Massachusetts Banks
Robert Maietta
Chief Counsel
Robert Leadbetter
Asst. Supervisor and Rate Analyst
Boston, Mass.

Hon. Preston Martin
Chairman
Eric Stattin
Director, Office of Examination and Supervision
Arthur W. Leibold, Jr.
General Counsel
Federal Home Loan Bank Board
Washington, D.C.

Ralph Nader
Center for Study of Responsive Law
Professor John A. Spanogle
Public Interest Research Group
Washington, D.C.

Frederic Solomon
Director, Division of Supervision and Regulation
Griffith Garwood
Jerauld Kluckman
Federal Reserve System
Washington, D.C.

Hon. Robert Timm
Member
O. D. Ozment
Deputy General Counsel
Richard J. O'Melia
Director, Bureau of Enforcement
Civil Aeronautics Board
Washington, D.C.

William D. Warren
Professor of Law
University of California
Los Angeles, Calif.

Hon. Justin Watson
Deputy Comptroller of the Currency
F. H. Ellis
Chief Examiner
Robert Bloom
Chief Counsel
Washington, D.C.

Richard L. Wheatley
Administrator
Oklahoma Department of Consumer Affairs
Oklahoma City, Okla.

Hon. Frank Wille
Chairman
John L. Flannery
Director, Division of Bank Supervision
William E. Murane
General Counsel
Federal Deposit Insurance Corporation
Washington, D.C.

Availability of Credit to Women
New Senate Office Building
Rayburn House Office Building
May 22 - 23, 1972

Witnesses

Hon. Bella S. Abzug
U.S. House of Representatives

Joseph W. Barr
President
American Security and Trust Company
Washington, D.C.

Lucille Bradley
Sears, Roebuck and Company
Atlanta, Ga.

Sharyn Campbell
Women's Legal Defense Fund
Washington, D.C.

Rep. Eugenia Chapman
Illinois State Legislature
Springfield, Ill.

Rep. Giddy Dyer
Illinois State Legislature
Springfield, Ill.

John P. Farry
President
U.S. Savings and Loan League
Washington, D.C.

Jorie Friedman
TV Newscaster
Chicago, Ill.

Sonia Pressman Fuentes
Attorney
Washington, D.C.

Janne Gallagher
Institute for Public Interest Representation
Georgetown University
Washington, D.C.

Hon. Martha W. Griffiths
U.S. House of Representatives

Mildred Hagan
Sears, Roebuck and Company
Boston, Mass.

Betty Howard
Director, Women's Division
Minnesota Human Rights Department
Minneapolis, Minn.

Elizabeth Duncan Koontz
Director, Women's Bureau
Deputy Assistant Secretary of Labor
Washington, D.C.

Lynne C. Litwiller
National Organization for Women
Seattle, Wash.

Dr. Josie McElhone
Economist
Washington, D.C.

Hon. Patsy T. Mink (written testimony)
U.S. House of Representatives

Steven M. Rohde
Center for National Policy Review
Catholic University Law School
Washington, D.C.

Dr. Bernice Sandler
Association of American Colleges
Washington, D.C.

Faith A. Seidenberg
American Civil Liberties Union
Syracuse, N.Y.

Homer L. Stewart, Jr.
Senior Vice President
Republic National Bank of Dallas
for American Bankers Association
Washington, D.C.

Jane M. Sullivan
Northport (L.I.) Federal Savings and Loan
for National League of Insured Savings Associations
Washington, D.C.

Quinton R. Wells
Director, Office of Technical and Credit Standards
Federal Housing Administration
Washington, D.C.

George B. Williams
Executive Director
Parents Without Partners, Inc.
Bethesda, Md.

COMMISSION STUDIES

National Commission on Consumer Finance Studies

The studies listed below are being published by the Commission and copies may be ordered from the Government Printing Office, Washington, D.C. 20401. Publication by the Commission does not imply its approval, but in many instances Commission findings, conclusions, and recommendations are, in part, based on the studies.

VOLUME I

1. Consumer Awareness of Annual Percentage Rates of Charge in Consumer Instalment Credit: Before and After Truth in Lending Became Effective	Robert P. Shay Milton W. Schober
2. A Study of Consumer Credit Decisions: Implications for Present and Prospective Legislation	George S. Day William K. Brandt
3. Credit Legislation Two Years Out: Awareness Changes and Behavioral Effects of Differential Awareness Levels	Terry Deutscher

VOLUME II

1. The Costs of Extending Consumer Credit at Consumer Finance Companies and Commercial Banks	George J. Benston
2. Continuous High Interest Rate Borrowing and Consumer Welfare: An Analysis of Maine's "36 Months Limitation" on Finance Company Small Loans	George J. Benston
3. A High-Rate Market for Consumer Loans: The Small Small Loan Industry in Texas	Thomas A. Durkin
4. Performance of Limited-Income Credit Unions: 1969-1970	Thomas F. Cargill

VOLUME III

A Statistical Compilation of Credit Rates, Extensions, and Outstandings in Consumer Credit Markets in the United States in 1971	Robert P. Shay Milton W. Schober

VOLUME IV

An Econometric Analysis of the Consumer Credit Market in the United States in 1971	Edited by Douglas F. Greer and Robert P. Shay
Part I, Paper I A Theory of Credit Rationing	Douglas F. Greer
Part I, Paper II Preliminary Model Specifications for the Personal Loan Market	Douglas F. Greer Robert P. Shay
Part I, Paper III Preliminary Model Specifications for the New Automobile Credit Market	Douglas F. Greer Robert P. Shay

VOLUME IV - Con'd

VOLUME V

VOLUME VI

The studies listed below and prepared for the Commission may be perused at the Records Center of the National Archives and Records Service, Washington, D.C.:

An Analysis of the Debt Positions of Poverty Area Families	Gary G. Chandler
A Study of Credit Granting Systems for Low-Income Consumers	Ronda F. Paul
An Inquiry into the Response of Durable Goods Retailers to a Reduction in the Statutory Ceiling on Consumer Credit Charges	Darrell A. McNabb
A Study of Deficiency Suits for Automobile Credit Transactions in the District of Columbia	Stephen M. Crane
A Study of the Costs of Extending Retail Sales Credit	Milton W. Schober
An Analysis of Credit Counseling Programs	Sylvia Lane

FOOTNOTES

Chapter 2

1. M. R. Neifeld, *Neifeld's Manual on Consumer Credit*, (Easton, Pa.: Mack Publishing Company, 1961), p. 16.

2. Edwin R. A. Seligman, *The Economics of Instalment Selling* (New York: Harper & Brothers, 1927), I, 42.

3. Irving S. Michelman, *Consumer Finance: A Case History in American Business*, (New York: Augustus M. Kelly, 1970), p. 108.

4. Collection procedures that are currently permitted may be compared to the "bawlerout" used in the late 1800's. These were female employees of salary loan offices and chattel loan offices "whose job was to go to the place of employment of the delinquent borrower and bawl him out in front of all his colleagues for not paying his bill." *Ibid.*, p. 80.

5. U.S. Department of Commerce, *Current Population Reports* (Series P-60, No. 83), July, 1972, p. 6.

6. U.S. Department of Commerce, *Special Studies* (Series P-23, No. 40), January, 1972, p. 7.

7. U.S. Department of Commerce, *Consumer Buying Indicators* (Series P-65, No. 40), May, 1972, p. 8.

8. William C. Dunkelberg and James Stephenson, *Durable Goods Ownership and the Rate of Return*, prepared for NCCF (1972), Table 5.

9. Board of Governors of the Federal Reserve System, *Supplement to Banking & Monetary Statistics, Section 16 (New), Consumer Credit* (Washington, D.C., 1965), p. 2.

10. The term "credit sale . . . includes any contract in the form of a bailment or lease if the bailee or lessee contracts to pay as compensation for use a sum substantially equivalent to or in excess of the aggregate value of the property and services involved and it is agreed that the bailee or lessee will become, or for no other or a nominal consideration has the option to become, the owner of the property upon full compliance with his obligations under the contract." P. L. 90-321, Consumer Credit Protection Act (CCPA), sec. 103(g), 15 U.S.C. 1602(g).

11. Uniform Consumer Credit Code (UCCC), sec. 2.106.

12. Board of Governors of the Federal Reserve System, *Supplement to Banking & Monetary Statistics, Section 16 (New), Consumer Credit*, p. 2.

13. UCCC, secs. 2. 104 and 3. 104.

14. CCPA, sec. 103(f), 15 U.S.C. 1602(f).

15. Truth in Lending, Regulation Z, Board of Governors of the Federal Reserve System, sec. 226.2(k). The more-than-four-instalment rule was established to exclude from coverage customary purchases of clothing and furniture on 90-day terms.

16. UCCC, sec. 2.104(d).

17. "Survey of Finance Companies, Mid-1965," *Federal Reserve Bulletin*, 53 (April, 1967), p. 536.

18. National Credit Union Administration, *Bulletin*, 2 (October, 1971), p. 31.

19. Some portion of this shift is statistical in nature, since the captive finance companies established by several large retailers to hold their instalment receivables are classified as finance companies.

20. *1971 Annual Report of the Administrator*, (Washington, D.C.: National Credit Union Administration, 1972) p. 6.

21. "Recent Developments in Consumer Instalment Credit," *Federal Reserve Bulletin*, 57 (September, 1971), p. 706.

22. 1971 Annual Report of the Administrator, (Washington, D.C.: National Credit Union Administration, 1972) p. 6.

23. Chapter XIII permits a wage earner to work out extension agreements with unsecured creditors under Court supervision and avoid discharge as a bankrupt. Bankruptcy data are contained in the *Annual Report of the Director of Administrative Office of the United States Courts*, 1971 (Washington, D.C.: U.S. Government Printing Office, 1972) pp. 227-238, 381-392.

24. Mary E. Ryan and E. Scott Maynes, "The Excessively Indebted. Who and Why," *J. Cons. Aff.* (1968) pp. 107-126.

25. *Ibid.*, p. 117.

26. George Katona, Lewis Mandell and J. Schmiedoskamp, *1970 Survey of Consumer Finances*, (Ann Arbor, Survey Research Center, University of Michigan, 1971), p. 34.

Chapter 3

1. Homer Kripke, "Consumer Credit Regulation: A Creditor-Oriented Viewpoint," 68 *Colum. L. Rev.* 445, 472 (1968). See also, Philip Shuchman, "Consumer Credit by Adhesion Contracts II," 35 *Temple L.Q.* 281, 284-287 (1962).

2. *Fuentes et. al.* v. *Shevin*, 407 U.S. 67, 92 S. Ct. 1983 (1972); *D. H. Overmeyer Co.* v. *Frick Co.*, 405 U.S. 174 (1972); *Adams* v. *Egley*, 338 F. Supp. 614 (S.D. Cal. 1972); *Unico* v. *Owen*, 50 N.J. 101, 232 A. 2d 405 (1967).

3. *Consumer Credit: Report of the Committee* (Chairman, Lord Crowther). Vol. 1 (London: Her Majesty's Stationary Office, 1971) p. 223 (Hereafter *Crowther Report*).

4. *Ibid.*

5. Black's, *Law Dictionary* p. 26 (Rev. 4th ed. 1968).

6. When the Code is quoted or referred to in the text no reference to specific Code sections will be footnoted.

7. See e.g., *Harris* v. *Kessler*, 124 Cal. App. 299, 12 P. 2d 467 (Dist. Ct. App. 1932).

8. 2A Bogert, *Uniform Laws Annotated*, sec. 101 (1924).

9. *Call* v. *Seymour*, 40 Ohio St. 670 (1884).

10. Williston, Contracts sec. 1696 (rev. ed. 1938); *Chicago Title & Trust Co.* v. *Kearney*, 281 Ill. App. 279 (1935).

11. *Leaf* v. *Reynolds*, 34 Idaho 643, 652, 203 P. 458, 460 (1921); *Spatuzzi* v. *Star Auto Truck Exch.*, 119 N.J. Law 377, 196 A. 723 (Ct. Err. & App. 1938).

12. 2 Gilmore, *Security Interests in Personal Property* sec. 43.1 (1965).

13. These samples are only illustrative and are not meant to exhaust the major provisions which might be grounds for default.

14. Note, "Confessions of Judgment," 102 *U. Pa. L. Rev.* 524, 526 (1954). Seventeen states void any agreement to confess judgment entered into prior to the commencement of suit. Comment "Clash in Ohio?: Cognovit Notes and the Business Ethic of the UCC," 35 *U. of Cincinnati L. Rev.* 470, 491 (1966). Twenty-two states either impose such substantial limitations on the use of confession of judgment clauses so as, in effect, to destroy their use as a swift and inexpensive method of entering judgment without going into the merits of a case. Four states leave no legislation regulating cognovit notes. *(Ibid.* p. 490) Only seven states specifically allow cognovit notes, but of these in only three, Illinois, Ohio and Pennsylvania, was there widespread use of such notes. *(Ibid.)*

15. Dan Hopson, Jr., "Cognovit Judgments: An Ignored Problem of Due Process and Full Faith and Credit," 29 *U. Chi. L. Rev.* III, 158 (1961).

16. *Ibid.*, p. 138.

17. *Swarb* v. *Lennox*, 314 F. Supp. 1091 (E.D. Pa. 1970).

18. *Swarb* v. *Lennox*, 405 U.S. 191 (1972).

19. 405 U.S. 191, (1972); *D. H. Overmeyer Co.* v. *Frick Co.*, 405 U.S. 174, 187 (1972).

20. 15 USC 1638(d).

21. The term default is not defined in the Code, and for the most part the security agreement must define the standards for determining whether default occurs. Some of the standards ordinarily used to determine default are: (1) failure to make a required payment of interest or principal; (2) unauthorized sale or transfer of the collateral; (3) the legal seizure of the collateral; or (4) the filing of a petition in bankruptcy or making an assignment for the benefit of creditors.

22. Grant Gilmore and Allan Axelrod, "Chattel Security," 57 *Yale L. J.* 517, 521-29, 530-38, 541-48 (1948).

23. Grant Gilmore, "Secured Transactions Article of the Commercial Code," 16 *Law and Contemp. Prob.* 27, 29 (1951). See generally, 1 Gilmore, *Security Interests in Personal Property* secs. 1.1 - 3.8 (1965).

24. Annot., 36 *A.L.R.* 853 (1925).

25. 3 W. Blackstone, *Commentaries*, p. 4.

26. *Kenny* v. *Planer*, 9 N.Y. C.P. 131, 134 (1869).

27. NCCF, Hearings on Collection Practices (June 23 & 24, 1970). See also, James J. White, "Representing the Low Income Consumer in Repossession, Resales and Deficiency Judgment Cases," 64 *Nw. U. L. Rev.* 808 (1970). Comment, "Non-Judical Repossession - Reprisal in Need for Reform," 11 *B.C. Ind. & Comm. L. Rev.* 435 (1970); Philip Shuchman, "Profit on Default: An Archival Study of Automobile Repossession and Resale," 22 *Stan. L. Rev.* 20 (1969).

28. 2 Gilmore, *Security Interests in Personal Property* sec. 44.1.

29. Stephen M. Crane, *The Aftermath of Repossession: Deficiency Suits for Automobile Credit Transactions in the District of Columbia.* NCCF Staff Study - Unpublished.

30. *Replevin Statutes - Laprease* v. *Raymours Furniture Co.*, 315 F. Supp. 716 (N.D. N.Y. 1970); *Blair* v. *Pitchless*, 5 Cal. 3d. 258, 486 P. 2d 1242 (1971). *Fuentes et. al.* v. *Shevin et. al.* 407 U.S. 67, 92 S. Ct. 1983 (1972).

Repossession - Adams v. *Egley* and *Posadas* v. *Star & Crescent Federal Credit Union*, 338 F. Supp. 614 (S.D. Cal. 1972).

As of August 1, 1972, twelve states had adopted legislation limiting to some extent the secured parties right to a deficiency judgment: Arizona, California, Colorado, Hawaii, Idaho, Illinois, Indiana, Oklahoma, Oregon, Utah, Wisconsin and Wyoming. Of the twelve, six have adopted the Uniform Consumer Credit Code, but only three have retained the UCCC's prohibition on deficiency to the sale of goods with a cash price of $1,000 or less. Colorado ($500), Utah ($1,100) and Wyoming ($500). See CCH *Consumer Credit Guide* (Colorado para. 4310; Utah para. 4310; Wyoming para. 4310).

31. 395 U.S. 337 (1969).

32. 407 U.S. 67, 92 S. Ct. 1983 (1972).

33. *Ibid.*, p. 1994.

34. 322 F. Supp. 604 (S.D. Fla. 1971).

35. 317 F. Supp. 954 (S.D. Fla. 1970).

36. The court in *McCormick* found no distinction between self-help repossession and replevin procedures when both were based on a private security agreement.

37. 338 F. Supp at 618.

38. *Ibid.*, pp. 618-619.

39. *Ibid.*, p. 620.

40. "We question that the fine print in the usual consumers conditional sales contract gives rise to competent and intelligent waiver of a constitutional right." *Laprease* v. *Raymours Furniture Co.*, 315 F. Supp. 716, 724.

41. 407 U.S. 67 at 95, 92 S. Ct. 1983, at 2002 (emphasis added).

42. *Ibid.*

43. *D. H. Overmeyer Co.* v. *Frick Co.,* 405 U.S. 174, 187; see also Second Concluding Remark at 188.

44. *Fuentes et. al.* v. *Shevin et. al.* 407 U.S. 67, at 81, 92 S. Ct. 1983, at 1994.

45.

1972 Cars	Gremlin	$1,759	6 cyl.	2 dr.
	Vega	1,727	4 cyl.	2 dr.
	Pinto	1,642	4 cyl.	2 dr.
	Duster	1,933	6 cyl.	2 dr.
		$7,061		

4/$7,061 = $1,765

46. George J. Benston, *The Cost of Consumer Loans at Consumer Finance Companies and Commercial Banks,* prepared for NCCF (1972).

47. NCCF, Hearings on Collection Practices (June 23 & 24, 1970).

48. Note, "Present Status of Execution Against the Body of the Judgment Debtor," 42 *Iowa L. Rev.* 306 (1957); Richard Ford, "Imprisonment for Debt," 25 *Mich. L. Rev.* 24 (1926); and Hunter, *Roman Law* 968 (ed. 1885)

49. Note, "Present Status of Execution Against the Body of the Judgment Debtor," pp. 308-309.

50. Black's *Law Dictionary* p. 810 (Rev. 4th Ed. 1968).

51. William E. Mussman and Stefan A. Riesenfeld, "Garnishment and Bankruptcy," 27 *Minn. L. Rev.* 1, 8 (1942-43).

52. A. Scott & R. Kent, *Cases and Other Materials on Civil Procedure,* pp. 433-448 (1967).

53. Morris, Select Cases of the Mayor's Court of New York City 1674-1784 (1935). Massachusetts Statute of October 1644. *Charters and General Laws of the Colony and Province of Massachusetts Bay* p. 49 (1814).

54. Proceedings and Acts of the General Assembly of Maryland of 1683, 7 *Maryland Archives,* p. 606 (1889)

55. Garnishment became an execution process for reaching property of the defendant in the hands of others on debts owed to the defendant. This phenomenon was clearly due to the situation under the original writs of execution (means of collecting) by which debts owned to the defendant would not be reached. See Massachusetts, 2 *Perpetual Laws of the Commonwealth,* Ch. 65 (1794). The art. bears the title, "act to enable creditors to receive their just demands out of the goods; effects and credits of their debtors when the same cannot be attached by the ordinary process of law."

56. J. Sweeney, "Abolition of Wage Garnishment," 38 *Ford L. Rev.* 197, 201-202 (1969).

57. 395 U.S. 337, 341-42 (1969)

58. Note, "Direct Loan Financing of Consumer Purchases," 85 *Harv. L. Rev.* 1409 (1972). Rosenthal, "Negotiability: Who Needs It?," 71 *Colum. L. Rev.* 375 (1971). Note, "Consumer Financing, Negotiable Instruments, and the Uniform Commercial Code: A Solution to the Judicial Dilemma," 55 *Cornell L. Rev.* 611 (1970). Comment, "Financing Consumer Goods Under the Uniform Commercial Code: Installment Buyers and Defaulting Sellers," 37 *U. Chi. L. Rev.* 513 (1970). Comment, Judicial and Statutory Limitations on the Rights of 'A Holder in Due Course' in Consumer Transactions," 11 *B.C. Ind. & Comm. L. Rev.* 90 (1969). Neil O. Littlefield, "Preserving Consumer Defenses: Plugging the Loophole in the New U.C.C.C.," 44 *N.Y. U. L. Rev.* 272 (1969); Homer Kripke, "Consumer Credit Regulation: A Creditor-Oriented Viewpoint," 68 *Colum. L. Rev.* 445, 459-473 (1968); Comment "Consumer Protection - The Role of Cut-Off Devices in Consumer Financing," 1968 *Wis. L. Rev.* 505; Symposium: "Consumer Credit: Developments in the Law," Finance Companies and Banks as Holders in Due Course of Consumer Instalment Credit Paper," 55 *Nw. U. L. Rev.* 389 (1961). Grant Gilmore, "The Commercial Doctrine of Good Faith Purchase," 63 *Yale L. J.* 1057, 1097-1100 (1954); Homer Kripke, "Chattel Paper as a Negotiable Specialty under the Uniform Commercial Code," 59 *Yale L. J.* 1209, 1215-1216 (1950).

59. 97 Eng. Rep. 398,402 (K.B. 1758).

60. *Ibid.* See also William C. Jones, "Finance Companies as Holders in Due Course of Consumer Paper," 1958 *Wash. U.L.Q.* 177, 183-185; J. Strong, *Promissory Notes* p. 13 (7th ed. 1878).

61. Bank of England notes became legal tender in 1833, 3 & 4 Wm. Iv ch. 9836. Farnsworth & Honnold, *Commercial Law* p. 29, n. 9 (ed. 1968).

62. Albert J. Rosenthal, "Negotiability: Who Needs It?," 71 *Colum. L. Rev.* 378; Waterman, "The Promissory Note as a Substitute for Money," 14 *Minn. L. Rev.* 313, 321-322 (1930); Ralph W. Aigler, "Commercial Instruments, the Law Merchant, and Negotiability," 8 *Minn. L. Rev.* 360, 378 (1924).

63. See, e.g., *Jones* v. *Approved Bankcredit Corp.,* 256 A. 2d 739 (Del. 1969); *American Plan Corp.* v. *Woods,* 16 Ohio App. 1d 1, 240 N. E. 2d 886 (1968); *Unico* v. *Owen,* 50 N.J. 101, 232 A. 2d 405 (1967); *Westfield Investment Co.* v. *Fellers,* 74 N.J. Super. 575, 181 A. 2d 809 (L. Div. 1962); *Commercial Credit Co.* v. *Childs,* 199 Ark. 1073, 137 S. W. 2d 260 (1940).

64. See, e.g., Cal. Civ. Code sec. 1810.7 (West. Supp. 1971) (goods), Cal. Civ. Code sec. 1802.5 (West Supp. 1971) (Services). Hawaii Rev. Stat. sec. 476-18, 476-1 (1968). Mass. Gen. Laws. Ann., chs. 255 sec. 12c, 255D sec. 10(6) (Supp. 1972). N.Y. Pers. Prop. Law sec. 403 (1), 401(7) (McKinney 1971); Utah Code Ann. 70B-2-404 (Supp. 1971); Vt. Stat. Ann., Tit. 9 sec. 2455 (1969); Rev. Code Wash. Ann. sec. 63.14.020 (1968). See Conn. Gen. Stat. Ann. sec. 42-134 to 42-143 (Supp. 1972) (limited to door-to-door sales). N.H. Rev. Stat. Ann. sec. 320 21-6 (Supp. 1971) (limited to home solicitation sales). See also U.C.C.C. sec. 2.403.

65. *Fairfield Credit Corp.* v. *Donnelly,* 158 Conn 543, 264 A. 2d 547 (1969); *Unico* v. *Owen,* 50 N.J. 101, 125, 232 A. 2d 405 418 (1967). *Quality Finance Co.* v. *Hurley,* 337 Mass. 150, 148 N.E. 2d 385 (1958).

496-072 O - 73 - 20

66. See, e.g., Alaska Stat. sec. 45.10.140 NO (1962); Cal. Civ. Code sec. 1804.2 (West Supp. 1971); Hawaii Rev. Stat. sec. 476-18 (d) (1968); Mass. Gen. Laws Ann., ch. 255D, sec. 10(6) and 25A (Supp. 1972). See also UCCC sec. 2.404 Alternative A.

67. See, e.g., Md. Ann. Code, Art. 83 sec. 147 (1969) (instalment sale of goods, does not seem to prohibit waiver of defense clauses); Miss. Code Ann. sec. 380 75-13 (i) (Supp. 1966) (probably prohibits all cut-off devices in Motor Vehicle retail instalment sales). Nev. Rev. Stat., ch. 97.275 (1967) (prohibits waiver of defense clauses in retail instalment sales contracts); N.M. Stat. Ann. sec. 5-16-5 (Supp. 1971) (prohibits only waiver of defense clauses in retail instalment sales contracts); Oreg. Rev. Stat. sec. 83.150 (1971) (prohibits waivers in retail instalment contracts for all goods except motor vehicles), Oreg. Rev. Stat. sec. 83.650 (1971) (prohibits the use of negotiable notes in retail instalment sale of motor vehicles, but waiver of defense clauses are permitted). Pa. Stat. Ann., Tit. 69, sec. 615 (f) & (g) (Purdon Supp. 1972) (prohibits the use of negotiable notes or contractual waivers in retail instalment sales of motor vehicles). Rev. Code of Wash. Ann. sec. 63.14.150 (Supp. 1971) (prohibits waivers in retail instalment sales of motor vehicles). Rev. Code of Wash. Ann. sec. 63.14.150 (Supp. 1971) (prohibits waivers in retail instalment sales contracts).

68. See, e.g., Del. Code Ann., Tit. 6, sec. 4312 (Supp. 1970) (15 day notification period covers all retail sales); Ill. Ann. Stat., ch. 121-½ sec. 262(d) (Smith-Hurd Supp. 1972) (5 day notification period covers all instalment sales except motor vehicles). Mich. Comp. Laws Ann. sec. 445.865(d) (1967) (15 day notification period covers all retail instalment sales except motor vehicles); Pa. Stat. Ann., Tit. 73 sec. 50-207 to 208 (Purdon Supp. 1972) (15 day notification period, home improvement retail instalment sales), Pa. Stat. Ann., Tit. 69 sec. 1402 (Purdon Supp. 1972) (45 day notification period covers all retail instalment sales except home improvement and motor vehicles); Tex. Rev. Stat. Ann., Art. 5069-6.07 to 7.08 (Vernon 1970) (30 day notification period covers all retail instalment sales).

69. Proposed FTC Reg. sec. 433.1, 36 Fed. Reg. 1211 (1971).

70. See National Consumer Act sec. 2.407 and Mass. Gen. Laws Ann., Ch. 255 sec. 12F (Supp 1971).

71. Albert J. Rosenthal, "Negotiability: Who Needs It?," 71 *Colum. L. Rev.* 376-381; Littlefield, "Preserving Consumer Defenses: Plugging the Loophole in the New UCCC," 44 *N.Y.U. L. Rev.* 272; Homer Kripke, "Consumer Credit Regulation: A Creditor-Oriented Viewpoint," 68 *Colum. L. Rev.* 469-473; Neil O. Littlefield, "Good Faith Purchases of Consumer Paper: The Failure of the Subjective Test," 39 *S. Cal. L. Rev.* 48 (1966); Grant Gilmore, "The Commercial Doctrine of Good Faith Purchase," 63 *Yale L.J.*, 1097-1102.

72. Federal Trade Commission, *Economic Report on Instalment Credit and Credit Sales Practices of District Columbia Retailers* (Washington, D.C.: U.S. Government Printing Office 1968).

73. Neil O. Littlefield, "Preserving Consumer Defenses: Plugging the Loophole in the New UCCC," 44 *N.Y.U. L. Rev.* 282.

74. *Crowther Report*, p. 285

75. Homer Kripke, "Consumer Credit Regulation: A Creditor-Oriented Viewpoint," 68 *Colum. L. Rev.* 472

76. Cohen, "The Uniform Consumer Credit Code - A Design for Disaster," 23 *Pers. Fin. L.Q. Rep.* 10 (1968)

77. Homer Kripke, "Consumer Credit . . . .Viewpoint," 473.

78. *Crowther Report*, sec. 6.2.22, 6.2.46, 6.6.24, 6.6.26; regarding liability of credit card issuers see sec. 6.12.1 - 6.12.11; see also Wisconsin Consumer Act, 1971 Assembly Bill 1057, Assembly Substitute Amendment 2 (Feb. 10, 1972) sec. 422.408.

79. 2 Freeman, *Judgments*, ch. 13 (5th ed. 1925).

80. P. L. No. 91-354.

81. Joe Lee, "The Counseling of Debtors in Bankruptcy Proceedings," 45 *Am. Bankr. L.J.*, 387-404 (1971).

82. The property of the consumer exemption recommended for in the section, Levy on Personal Property, should also apply to Bankruptcy proceedings.

The expansion of Ch. XIII of the Bankruptcy act as endorsed by the House of Delegates of the American Bar Association is as follows:

1. Encourage greater use of Chapter XIII by:

   a. expanding the eligibility to file under Chapter XIII to include all natural persons whose indebtedness is $100,000 or less regardless of their sources of income but excepting those business debtors whose creditors would better be served by a different proceeding. Under the present Act relief under Chapter XIII is available only to "Wage Earner Debtors." Relief is not available to professional people or individuals in business for themselves, or persons employed on a commission basis and others not employed on a wage or salary basis.

   b. eliminating the peril of forfeiting the right to a discharge in bankruptcy within six years if the debtor has a plan by way of composition confirmed.

   c. eliminating as a bar to confirmation of a plan by way of composition the fact that the debtor has obtained a bankruptcy discharge within six years.

2. Improve Chapter XIII administration by:

   a. reducing the time in which creditors can file proofs of claims from six months to 60 days.

   b. requiring a copy or summary of the proposed plan, together with a proof of claim form to accompany the notice of first meeting of creditors.

   c. eliminating the requirement for a final meeting of creditors when a debtor's plan is terminated by requiring that each creditor be notified of the termination and given an accounting of all monies received and disbursed.

3. Clarify the status of the Chapter XIII trustee by:

   a. providing for a standing Chapter XIII trustee when the number of debtor plans under administration is substantial.

b. providing that the Chapter XIII trustee is more than a distributing agent and has the rights, powers and defenses granted a trustee under sections 60, 67, 70c and 70e of the Bankruptcy Act to the extent appropriate; and

c. providing that the Chapter XIII trustee can receive monies from a debtor and otherwise function as a trustee prior to confirmation of the plan.

4. Provide for uniform treatment of deficiency claims.

5. Permit allowance under certain conditions of post-petition claims for property or services necessary to enable the debtor to carry out the plan.

6. Insure that unsecured creditors get fairer treatment by:

a. modifying the priority provisions of sections 659 for debtors' attorneys' and trustees' fees, commissions or expenses;

b. requiring the secured creditor to prove his security and so much of his claim as exceeds the value of the security shall be an unsecured claim;

c. encouraging payments of unsecured debts to be made concurrently with payments of secured debts dealt with under the plan; and

d. empowering the court to prevent a secured creditor from defeating confirmation of a plan if the court finds the plan adequately preserves the value of the debt of the secured creditor.

7. Require uniformly that damages resulting from the rejection of executory contracts be mitigated.

8. Provide for uniform treatment in stopping interest on claims.

9. Permit the Chapter XIII court under certain conditions, to alter or modify the rights of secured creditors when it finds that the plan adequately protects the value of the collateral of the secured creditor.

Further resolved, That the Section of Corporation, Banking and Business Law is directed to urge upon the proper committees of Congress the amendments below described in the Report, or their equivalent in purpose and effect, either independently or as part of appropriate legislation which is presently or may hereafter be pending.

83. Letter from Professor Vern Countryman, Law School of Harvard University to NCCF (Sept. 21, 1971). See also UCCC sec. 6.111 (3) (a).

84. See Linn K. Twinem, *Bankruptcy Guide for Consumer Finance Companies,* Ch. IV (6th ed. 1964), and statement in National Credit Union Administration Research Report, *Loan Delinquency in Federal Credit Unions,* Appendix B, sec. VIII p. 41 (No. 4 (1971)

"Bankruptcy or Chapter XIII Proceedings:
4. If borrower states he has filed, get his attorney's name and address so the credit union can verify. Question him about *reaffirmation* and explain to him that he may be able to retain a good credit rating with his credit union if he continues to pay his loan. (People who file bankruptcy frequently do not know this.)" (Emphasis added).

Chapter 4

1. An excellent survey of consumer credit legislation is Barbara Curran, *Trends in Consumer Credit Legislation* (1965)

2. P. L. 90-321, 15 U.S.C. 1601, *et seq.*

3. The movement is documented in Michelman, *Consumer Finance: A Case History in American Business* (1966).

4. See *Bette* v. *Bidgood,* 7 B&C 453, 108 Eng. Rep. 792 (K.B. 1827). The leading American case is *Hogg* v. *Ruffner,* 66 U.S. (1 Black) 115 (1861). Many cases on the doctrine are marshalled in 6, *Williston, Contracts,* sec. 1865 (3d ed. 1938).

5. Archie K. Davis, "Bank Regulation Today, A Banker's View," 31 *Law & Contemp. Prob.* 639 (1966). See also Statement of Professor George J. Benston, NCCF Hearings, June 22, 1971. p. 1.

6. "The ability of state banking departments to prevent or correct those bank activities deemed unsound, or not in compliance with banking laws, rests on their ultimate authority to close a bank. Thus, to a large extent supervisory procedures are informal in nature and it is not often that state banking departments utilize formal procedures (such as hearings) or resort to courts to accomplish supervisory objectives. This is so whether or not the state has specific cease and desist and officer removal authority since even in such instances - which would include the large majority of states - state supervisors generally prefer to carry out their duties without resorting to the use of these express powers." Golembe & Haywood, *The Supervision of State Banks: Purposes, Standards and Responsibilities,* p. 24.

7. Benston, *Bank Examination,* pp. 7, 15. (Paper prepared for The President's Commission on Financial Structure and Regulation.)

8. Robert W. Johnson, "Regulation of Finance Charges on Consumer Instalment Credit," 66 *Mich. L. Rev.* 81, 82 (1967).

9. The Seventh Draft of the Uniform Small Loan Law is set out in Curran, *Trends in Consumer Credit Legislation,* pp. 144-157. The "convenience and advantage" provision is found in Section 4(b) of The Uniform Small Loan Act.

10. Curran, *Trends in Consumer Credit Legislation,* p. 2.

11. Ibid., pp. 118-119.

12. Uniform Consumer Credit Code Art. 6 describes the powers and functions of the administrator.

13. *Comptrollers Manual for National Banks, Regulations of the Comptroller of the Currency* sec. 1.1.

14. In the exercise of the Comptroller's discretion he may waive one such examination, but no more than one waiver every two years or cause such examinations to be made more frequently if deemed necessary.

15. P. L. 89-695, 80 Stat. 1028, 12 U.S.C. 1464, 1818. Further references to or quotations of the powers and responsibilities of the Federal agencies will not be footnoted, but may be found in those sections of Title 12 of the *United States Code* dealing with the respective agencies.

16. Preamble Federal Reserve Act of 1913, Dec. 23, 1913, 38 Stat. 251.

17. Act June 16, 1933, c. 89 Sec. 8, 48 Stat. 168. This provision added section 12B to the Federal Reserve Act, Dec. 13, 1913 and is now classified 12 U.S.C. 1811, *et seq.*

18. *Freeling* v. *Fed. Dep. Ins. Corp*:, 221 F. Supp. 955, 956 (W. D. Okla. 1962) affirmed 326 F.2d 971 (1963); see 1950 U.S. Code Cong. Service 3765 et seq.

19. Congress withdrew section 12B of the Federal Reserve Act of 1913, and by the Act of Sept. 21, 1950, established in Title 12 USC a Chapter to be known as the "Federal Deposit Insurance Act."

20. Statement by Frank Wille, Chairman, Federal Deposit Insurance Corporation, before the NCCF June 23, 1971, p. 1.

21. Benston, *Bank Examination*, Table IX.

22. *Ibid.*

23. Golembe & Haywood, *The Supervison of State Banks: Purposes, Standards and Responsibilities*, p. 18.

24. *Annual Report of the Federal Deposit Insurance Corporation - 1971*, p. 18.

25. *Annual Report of the Federal Deposit Insurance Corporation - 1969*, pp. 13-14.

26. Wille, Statement before NCCF, p. 2. Golembe & Haywood, *The Supervision of State Banks: Purposes, Standards and Responsibilities*, p. 19.

27. Golembe & Haywood, *The Supervision of State Banks: Purposes, Standards and Responsibilities*, p. 12.

28. Statement of Preston Martin, Chairman, Federal Home Loan Bank Board before NCCF, June 23, 1971, p. 1.

29. *Ibid.*

30. *Ibid.*, p. 3.

31. This agency is the successor to the Bureau of Federal Credit Unions, a division of the Department of Health, Education and Welfare.

32. Golembe & Haywood, *The Supervision of State Banks: Purposes, Standards and Responsibilities*, p. 22.

33. Curran, *Trends in Consumer Credit Legislation*, pp. 45, 60-61.

34. Uniform Small Loan Act, Seventh Draft, sec. 4(b) (1), (2), & (3). This determination is made by examining "the financial responsibility, experience, character and general fitness of the applicant;" by determining whether "allowing such applicant to engage in business will promote the convenience and advantage of the community in which the licensed office is to be located;" and by determining whether the applicant has "liquid assets of at least $20,000."

35. Robert P. Shay, "State Regulation and the Provision of Small Loans," in John M. Chapman & Robert P. Shay, *Consumer Finance Industry: Its Costs and Regulation* (New York: Columbia Univ. Press, 1967) pp. 88-89.

36. Curran, *Trends in Consumer Credit Legislation*, p. 117.

37. *Ibid.*

38. *Report on the Office of Attorney General*, published by National Association of Attorneys General, February, 1971.

39. *Ibid.*, pp. 395-440

40. Maine, Oklahoma, Massachusetts, Connecticut, and Wyoming.

41. Opening statement by Chairman Ira M. Millstein, NCCF Hearings, June 22, 1971.

42. See William E. Murane, "The FDIC and Bank Regulations," 89 *The Banking Law Journal* 483, 496-497.

43. Golembe & Haywood, *The Supervision of State Banks: Purposes, Standards and Responsibilities*, p. 119.

44. *Ibid.*, pp. 109 and 46-47.

45. This figure represents the responses of 46 of the 50 states to the Conference of State Bank Supervisors questionnaire which was prepared in collaboration with the Commission staff.

46. Golembe & Haywood, *The Supervision of State Banks: Purposes, Standards and Responsibilities*, p. 110.

47. *Ibid.*, p. 119.

48. *Ibid.*, p. 1.

49. Benston, *Bank Examination*, p. 56.

50. Letter from J. L. Robertson, Vice-Chairman, Board of Governors of the Federal Reserve System to Ira M. Millstein, Esq., Chairman, *NCCF* September 17, 1971 (original emphasis).

51. *Anderson National Bank* v. *Luckett*, 321 U.S. 233, 248 (1944).

52. *Casey* v. *Adams* 102 U.S. 66 (1880). This would also seem to apply to a national bank's security interest under Article 9 of the UCC, or the negotiability of an instrument under Article 3 of the UCC. See *Jennings* v. *United States Fidelity and Guaranty Co.*, 294 U.S. 216 (1935) and *Merchants National Bank* v. *Ford* 124 Ky 403, 99 S.W. 260 (1907).

53. A delay of one year was authorized by Congress.

54. Andrew Hacker, *Corporate America*, (New York: Harper and Row, 1965), p. 10; Milton Friedman, A Libertarian Speaks, *Trial*, 22 (Jan-Feb 1972); *President's Advisory Council on Executive Reorganization*, (Jan. 30, 1971).

55. The number of man-days per office available each year in each state was computed using the following formula:

$$\frac{(E_n)\,(WD)}{On} = \text{Man-days per office per year}$$

Where E_n = Number of examiners

WD = Working days per year (assumed in every case to be 240).

On = Number of offices to be examined

56. Several states had figures which were inexplicably high and these figures were excluded in reaching a median figure. In addition, all states did not respond and several states did not break down their examination forces for each type of institution supervised. (See Exhibits 4-1 and 4-10.)

57. Information provided by the National Association of Consumer Credit Administrators.

58. Professor William D. Warren, Statement before the NCCF, Hearings June 22, 1971.

59. *Report of The President's Commission on Financial Structure and Regulation,* 87, 91, and see chart on 93 (Dec. 1971).

Chapter 5

1. The term "credit insurance" is also sometimes used to describe the insurance protection purchased by credit grantors to indemnify them against loss from failure to collect accounts receivable. However, this is more appropriately called "bad debt insurance" and is not to be confused with the meaning of the term "credit insurance" as used in this chapter.

2. Harry Blythe, *Summary of the Credit Insurance Premium Rate Proposals of the Consumer Credit and Disability Insurance Study at Ohio University.* (Athens, Ohio: Ohio University, 1970), p. 1 of appendix. (Hereafter, *Summary of the Credit Insurance Premium Rate Proposals.*)

3. These are exceptions. Some states require that the life insurance company issued individual insurance policies to debtors with the creditor acting as agent. This is not an individual life insurance policy, in the conventional sense, because insurance is sold in the same manner and at about the same rates as it would be if it were group insurance.

4. *Life Insurance Fact Book,* 1971, (New York: Institute of Life Insurance, 1971), p. 34.

5. Kenneth C. Foster, "Credit Life and Health Insurance": in Davis W. Gregg, editor, *Life and Health Insurance Handbook,* 2nd edition (Homewood, Ill.: Richard D. Irwin, Inc., 1964).

6. *Ibid,* p. 397.

7. *Ibid.,* p. 395. As with credit life insurance, some states require that only individual contracts can be sold in connection with credit transactions. The coverage and form of these individual contracts are usually identical with a group policy. The difference is one of form to comply with state law rather than one of substance.

8. See Bruce W. Clements, *A Background Study of the Regulation of Credit Life and Credit Disability Insurance* (Milwaukee: National Association of Insurance Commissioners, 1970), pp.39-51

9. Robert A. Miller, *The Pennsylvania Insurance Department Enforcement Program—An Approach to the Enforcement of State Regulations Governing Credit Life Insurance and Credit Accident and Health Insurance,* prepared for NCCF, Unpublished.

10. Robert E. Younger, *Memorandum of the Prudential Insurance Company of America on the Credit Insurance Hearings before the United States Senate Anti-Trust and Monopoly Subcommittee of the Committee on the Judiciary* (Neward: 1968); p. 1. (Hereafter, *Memorandum of the Prudential Insurance Company of America.)* See also Statement by Philip A. Hart, Chairman of the Anti-Trust and Monopoly Subcommittee at the Conclusion of Hearings into Consumer Credit Insurance, December 21, 1967.

11. Younger, *Memorandum of the Prudential Insurance Company of America,* p. 3.

12. *Consolidated Annual Report of Registered Lenders,* December 31, 1971, State of Missouri, Department of Business and Administration, Division of Finance.

13. Blythe, *Summary of the Credit Insurance Premium Rate Proposals,* p. 2.

14. Clements, *A Background Study of the Regulation of Credit Life and Disability Insurance,* pp. 67-78.

15. For an excellent study of credit life insurance mortality costs, see Stanley W. Ginery and W. Harold Bittle, "A Study of Credit Life Insurance Mortality," *Transactions of The Society of Actuaries,* Volume XVII, Meeting No. 49, October, 1965.

16. Blythe, *Summary of the Credit Insurance Premium Rate Proposals,* P. 2.

17. Clements, *A Background Study of the Regulation of Credit Life and Disability Insurance,* pp. 69-71.

18. This table was taken from a letter from Robert E. Younger, Director, Government Affairs, The Prudential Insurance Company of America to Louis T. Masters, Commissioner of Insurance, State of Nevada, January 16, 1969.

19. Blythe, *Summary of the Credit Insurance Premium Rate Proposals,* p. 13.

20. *Ibid.,* p. 3

21. Testimony of John C. Waters, Vice President, First of Orlando Corporation at a Public Hearing before The Staff of the Board of Governors of the Federal Reserve System, March 24, 1972.

22. T. W. Holliday, Executive Vice President, Hamilton Bancshares, Inc., Statement in support of application of Hamiltom Bancshares, Inc. to Board of Governors of The Federal Reserve System to secure approval to purchase Bancshares Life Insurance Company.

23. An interesting approach to regulating insurance rates is making the creditor a "fiduciary" of the debtor. The Commission considered this approach but decided against adopting it. Basically, the idea would require a creditor offering credit insurance to act as a fiduciary *vis-a-vis* the debtor as regards the insurance. This would call for his obtaining the "best buy" in insurance for the debtor and for his accounting to the debtor for any profits beyond a reasonable fiduciary fee. Apart from administrative problems that seem obvious, the Commission believes that this approach would be impractical. In a sales credit transaction, for example, the creditor is not considered a fiduciary concerning the price or quality of the goods, nor is he considered a fiduciary concerning the finance change. Since the credit insurance charge is always the smallest dollar item of a typical sales credit transaction, it would not be feasible to create a new legal obligation for that item alone. (For a discussion of these issues, see Clements, *A Blackground Study of The Regulation of Credit Life and Credit Disability Insurance*, pp. 132-135; Paul R. Moo, *Credit Insurance Revisited, A Reply to the NAIC Staff Study* (South Bend, Inc., March, 1972) pp. 46-47; A letter from Richards D. Barger, Chairman of the Executive Committee, National Association of Insurance Commissioners to Arthur F. Burns, Chairman, Board of Governors of the Federal Reserve System, April 12, 1971.

Chapter 6

1. Milton Friedman, "Defense of Usury," *Newsweek*, April 6, 1970, p. 79.

2. Testimony of Leon Keyserling, Hearings before the Subcommittee on Consumer Affairs ot the Committee on Banking and Currency, House of Representatives, 90th Cong., 1st Sess. on H.R. 11601 (Consumer Credit Protection Act), Pt 2, p. 731.

3. Sidney Homer, *A History of Interest Rates* (New Brunswick, N.J.: Rutgers University Press, 1963), pp. 22-23.

4. *Ibid.*, p.30.

5. *Ibid.*

6. *Ibid.*, p. 42

7. *Ibid.*, pp. 41, 43.

8. *Ibid.*, p. 45.

9. *Ibid.*, p. 59.

10. Thomas F. Divine, *Interest–An Historical and Analytical Study in Economics and Modern Ethics* (Milwaukee: The Marquette University Press, 1959), p. 3.

11. Leviticus 25:35-37.

12. Deuteronomy 23:19-20.

13. Homer, *A History of Interest Rates*, p. 70.

14. *Ibid.*

15. *Ibid.*, pp. 72-73.

16. Irving S. Michelman, *Consumer Finance: A Case History in American Business* (New York: Augustus M. Kelley, 1970), p. 29. The Provident Loan Society is still in operation with more than 15 offices throughout New York City.

17. Joseph T. Noonan, Jr., *The Scholastic Analysis of Usury* (Cambridge, Mass.: Harvard University Press, 1957), citing Maurice Weber, *Less Origines des Montes de Pietes* (Rixheim, 1920), pp. 46-52, 64, p. 295.

18. Robert P. Shay, unpublished memorandum to NCCF on "Rate Ceilings." (June 29, 1972) pp. 14-15.

19. Homer, *A History of Interest Rates*, p. 80-81.

20. *Ibid.*

21. *Ibid.*, 126

22. The Usury Laws Repeal Act of 1854, 17 & 18 *Vict. Law Journal* 116, c. 90.

23. The doctrine has been upheld with respect to closed end sales credit in all states except Arkansas and Nebraska. It has been subject to challenge with respect to open end, or revolving credit in several states, most notably in Wisconsin.

24. Michelman, *Consumer Finance: A Case History in American Business*, p. 110.

25. Ch. 419 [1909] Mass. Acts, now Mass. Gen. Laws Ann. Ch. 171 (1972)

26. Michelman, *Consumer Finance: A Case History in American Business*, p. 200.

27. Marion Benfield, "Money, Mortgages, and Migraine–The Usury Headache," 19 *Case W. Res. L. Rev.* 840, 847-852 (1968).

28. *Ibid.*, p. 857.

29. Homer, *A History of Interest Rates*, p. 81.

30. Barbara A. Curran, *Trends in Consumer Credit Legislation* (Chicago: University of Chicago Press, 1965).

31. *Cost of Personal Borrowing in the United States*, 2nd ed. (Boston: Financial Publishing Company, 1972), p. 222.

32. *Wall Street Journal*, August 15, 1972, p. 8.

33. *Consumer Credit: Report of the Committee* (Chairman, Lord Crowther), vol. 1, (London: Her Majesty's Stationary Office, 1971) p. 160 (hereafter, *Crowther Report*).

34. *Reading Trust, Ltd.* v. *Spero*, 1929, All Eng. L. Rep. 405.

35. *Crowther Report*, p. 276.

36. Can. Rev. Stat., Ch. 5-11 (1970). Can. Rev. Stat. C. S-11 (1970).

37. *Report of the Royal Commission on Banking and Finance* (Ottawa: Queen's Printer, 1964), p. 382.

38. Quebec's Installment Sales Act of 1947 (now Quebec Civil Code, Article 1561e) applies to the credit sale of consumer goods other than automobiles and limits the rate on balances not exceeding $800 to 3/4 of one percent per month, calculated on the declining unpaid balance. (Repealed July 21, 1971.)

39. Criminal Code, STGB, secs. 302(a) to 302(e); Civil Code, BGB, sec. 138.

40. The conditions leading to usury are very similar to those set forth in note 2 of the "comment" to sec. 5.108 of the Uniform Consumer Credit Code.

41. Decret-loi du 8 anot 1935; and Loi no. 66;1010 du 28 decembre 1966.

42. *Instalment Credit Trading in New Zealand* (Report to the Minister of Industries and Commerce by the Tariff and Development Board (Wellington: A. R. Shearer, Government Printer, 1968), p. 71.

43. *The Law Relating to Consumer Credit and Moneylending* - Report to the Standing Committee of State and Commonwealth Attorneys-General (Adelaide: Law School, University of Adelaide, 1969), p. 41.

44. F. Thomas Juster and Robert P. Shay, *Consumer Sensitivity to Finance Rates: An Empirical and Analytical Investigation* (New York: National Bureau of Economic Research, 1964), pp. 2-3.

45. George S. Day and William K. Brandt, *A Study of Consumer Credit Decisions: Implications for Present and Prospective Legislation* prepared for NCCF, (1972), Table 3-12.

46. Edward C. Fritz, "Would the Uniform Consumer Credit Code Help the Consumer?" *Bus. Law.* 25 (January, 1970), p. 512.

47. See, for example, Robert P. Shay, *New-Automobile Rates 1924-1962* (New York: National Bureau of Economic Research, 1963), pp. 9-12; Allen F. Jung, "Charges for Appliance and Automobile Instalment Credit in Major Cities," *J. Bus.* 35 (October, 1962), pp. 386-391; "Commercial Bank Charges in New York and Ontario," *Nat. Bank. Rev.* 2 (March, 1965), pp. 397-401; "Dealer Pricing Practices and Finance Charges for New Mobile Homes," *J.Bus.* 36 (October, 1963), pp. 430-439; "Terms on Home Improvement Loans," *Nat. Bank. Rev.* 2 (September, 1964), pp. 51-60; *Special Report of the Superintendent of Banks of the State of New York Relative to Licensed Lenders*, 1940, p. 16, cited in John M. Chapman and Robert P. Shay, *Licensed Lending in New York* (New York: Graduate School of Business, Columbia University, 1970), p. 7; Paul F. Smith, "Pricing Policies on Consumer Loans at Commercial Banks," *J. Fin.* 25 (May, 1970), p. 518.

48. Milton W. Schober and Robert P. Shay, *State and Regional Estimates of the Price and Volume of the Major Types of Consumer Instalment Credit in Mid-1971* (Washington, D.C.: *NCCF* 1972). Robert P. Shay, *The Impact of State Legal Rate Ceilings Upon the Availability and Price of Consumer Instalment Credit* (Washington, D.C.: NCCF, 1972)

49. Schober and Shay, *State and Regional Estimates of the Price and Volume of the Major Types of Consumer Instalment Credit in Mid-1971.* Numerous other tables are presented in this study, none of which support the assertion that prices always go to the ceiling. Only when the ceiling is set at or below the market price are prices at the ceiling.

50. Adam Smith, *The Wealth of Nations,* ed. Edwin Cannan (New York: Modern Library, 1937), p. 339.

51. Jeremy Bentham, *Defence of Usury Shewing the Impolicy of the Present Legal Restraints on the Terms of Pecuniary Bargains; in Letters to a Friend to Which is Added a Letter to Adam Smith, Esq. LL.D. on the Discouragements Opposed by the Above Restraints to the Progress of Inventive Industry,* 3rd ed. (London: Payne and Foss, Pall-Mall, 1816), p. 29.

52. "Assets Used and Useful" is a measure of the rate base advocated by the Russell Sage Foundation which was used in some states to justify rate ceiling changes. The measure involved multiplying estimated average loan balances outstanding by 115 percent to approximate total "used and useful assets" of licensed lenders. For one such application, see *Special Report of the Superintendent of Banks of the State of New York Relative to Licensed Lenders,* 1940, pp. 8-11.

53. John M. Chapman and Robert P. Shay, *Licensed Lending in New York* (New York: Columbia University, Graduate School of Business, 1970), pp. 8-9.

54. Rolf Nugent, "Three Experiments with Small-Loan Interest Rates," *Harv. Bus. Rev.* 12 (October, 1933), pp. 35-46.

55. It is true, however, that as the rate charged moves higher and higher, it eventually enters an upper region where a court might view it, not just as unfair, but as *unconscionable.* As has been seen above, the issue of unconscionability can be tested on a case-by-case basis and is open to such a test in most other developed countries.

56. The evidence from the Commission's studies showing that the *average* annual percentage rates (as defined in regulation Z) typically charged on personal loans of $1,000 by commercial banks in five states in mid-1971 exceeded the legal rate ceiling strongly suggests either a lack of enforcement of rate ceilings applicable to commercial banks or state laws which prescribe or permit rate ceiling computations different from the method required by regulation Z. Since this Commission condones neither evasion nor lack of enforcement, the analysis that follows proceeds on the assumption that, if rate ceilings are imposed on cash credit, they do not provide opportunities for evasion and are enforced. Evidence suggests that this is generally, but may not always be, true of the real world.

57. Unless, for other reasons, including the fear of further regulation, lenders accept some unprofitable loans in order to maintain the *status quo.*

58. Statement of Capt. John M. Seidl, U.S. Military Academy, West Point, N.Y., Hearings on Consumer Credit Regulations (Proposed Uniform Consumer Credit Code) before the Subcommittee on Consumer Affairs, House of Representatives, 91st Cong., 1st Sess., Part 1, p. 182.

59. Federal Trade Commission, *Economic Report on Instalment Credit and Retail Sales Practices of District of Columbia Retailers,* p. 14.

60. *Ibid.*, p. 21.

61. William C. Dunkelberg, *A Lower Rate Maximum for Retail Credit: The Impact on Consumers*, prepared for NCCF, 1972)

62. George Katona et. al., *The 1967 Survey of Consumer Finances* (Ann Arbor: Survey Research Center, University of Michigan, 1967).

63. Dunkelberg, *A Lower Rate Maximum for Retail Credit: The Impact on Consumers*, p. 16.

64. Data for manufacturing firms are reported in *Economic Report of the President* (1971), pp. 284-285. Data on department stores are from *Financial and Operating Results of Department and Specialty Stores in 1969* (New York: Controllers Congress, National Retail Merchants Association, 1970) p. x-xi. The latter set of data is based on reports from 133 retailers with aggregate sales of $5.07 billion. The "all department stores" figure is an average of "typical" figures for each volume Classification, weighted by the Aggregate net sales of the companies reporting in each classification.

65. Leo Perlis, "The Social Costs of Consumer Credit," address delivered at Annual Convention, National Consumer Finance Association, San Juan, Puerto Rico, May 10, 1972.

66. Gene C. Lynch, "Consumer Credit at Ten Per Cent Simple: The Arkansas Case," 1968 *U.Ill. L.F.* 592, 601.

67. Hearings before Subcommittee on Consumer Affairs of the Committee on Banking and Currency, House of Representatives, 90th Cong., 1st Sess. on H.R. 11601, Consumer Credit Protection Act, Pt. 1, p. 94.

68. *Economic Characteristics of Department Store Credit.* (New York: National Retail Merchants Association, 1969), p. 63.

Chapter 7

1. In this discussion of rates and credit availability, it is assumed that credit terms other than rates are identical.

2. As discussed more fully in Chapter 3, it may be desirable from the standpoint of public policy to restrict certain remedies that are throught to be unduly oppressive, even though the cost to consumers is a reduction in the availability of credit.

3. The study prepared for the Commission by George J. Benston indicates that a loan office must double in size in order to gain a 14 percent reduction in unit costs. Presumably, even these minor economies of scale dwindle further beyond some point. George J. Benston, *The Cost of Consumer Loans at Consumer Finance Companies and Commercial* Banks, prepared for NCCF (1972).

4. Unless otherwise specified, the information and evidence presented in the remainder of this chapter is drawn from Douglas F. Greer and Robert P. Shay, Eds., *An Econometric Analysis of Consumer Credit Markets in the United States* (Washington, D.C.: National Commission on Consumer Finance, 1972).

5. *1970 Annual Report of the Administrator* (Washington, D.C.: National Credit Union Administration, 1971) p. 4. Of the dollar amounts outstanding, 17.9 percent was to finance new cars and 11.3 percent to finance used cars. The data base provided the Commission by credit unions was less extensive than that available from banks and finance companies.

6. Computed by multiplying the regression coefficient by the difference in the natural logs of 5 and 6 percent.

7. For more detailed analysis of the other new auto interest rates, see Douglas F. Greer and Ernest A. Nagata, "An Imperical Analysis of the New Automobile Credit Market" in Greer and Shay, Eds., *An Econometric Analysis of Consumer Credit Markets in the United States.*

8. The five states in each group were selected from a larger group of ten states in each category. Final selections were made on the basis of data availability and, insofar as possible, a dispersion of geographic location. See Exhibit 7-6 for a listing of the five states in each group.

9. The staff studies show that this association exists even when alternative measures of bank concentration and bank efficiency and the average size of banks and branch offices are taken into consideration.

10. Direct loans from finance companies can also be used to fiance the purchase of other consumer goods, but they are not treated here because of insufficient information regarding the purpose of making such loans.

11. Higher risk borrowers may, of course, obtain personal loans from finance companies. If these data were available, the retailers' and other shares of the market would be shown to be less.

12. Credit Union data were obtained from a 1971 survey conducted by the Credit Union National Association (unpublished). Other data are based on the National Commission on Consumer Finance Survey of Consumer Credit Volume, Second Calendar Quarter, 1971 and Consumer Credit Outstanding, June 30, 1971.

13. See, for example, Frederick W. Bell and Neil B. Murphy, Costs in Commercial Banking: *A Quantitative Analysis of Bank Behavior and Its Relation to Bank Regulation* (Boston: Federal Reserve Bank of Boston, 1968).

14. In states with graduated rate ceilings, the rate ceiling variable was computed under the small loan laws as the simple average of the ceiling for $100 loans, $200 loans, $300 loans, etc., up to the legal loan size limit.

15. For other segments of the market the Commission has no such measure.

16. The failure of restrictions or prohibitions of creditors' remedies (like garnishment) to affect adverserly the supply of bank personal loan credit in a noticeable way might be explained by a number of conditions which distinguish this segment of the market from the finance company segment, where restrictions on remedies did adversely affect availability. One major explanation could be that since banks customarily serve mainly low risk borrowers, formal remedies are not utilized as often (per average account) as they are by finance companies.

17. The mere fact that borrowers at high rate finance companies would most likely be willing to pay lower interest charges than those offered by finance companies suggests that demand exceeds supply at the lower bank level of interest rates.

18. The failure of bank personal loan supplies to be responsive to variations in creditor remedies may be due to their relatively conservative standards of risk acceptance, which would tend to limit their reliance on remedies for making collections. Credit unions probably have closely comparable standards of risk acceptance, but, where possible, they rely heavily upon wage assignments (or wage deductions) as a convenient and efficient means of receiving repayments, which probably explains the observed negative association between restrictions on wage assignments and credit union supplies, but no such association for banks.

19. On focal point pricing, see F. M. Scherer, "Focal Point Pricing and Conscious Parallelism." *The Antitrust Bulletin* (Summer 1967), pp. 495-503.

20. The Commission is not alone in finding that ease of entry into the market promotes improved performance. See David Motter and Deane Carson, "Bank Entry and the Public Interest: A Case Study" and David Motter, "Bank Formation and the Public Interest," both in *Studies in Banking Competition and the Banking Structure, Articles Reprinted from the National Banking Review,* The Administrator of National Banks, U.S. Treasury (Jan. 1966) pp. 187-284.

21. Donald Jacobs, "The Framework of Commercial Bank Regulation: An Appraisal," *Studies in Banking Competition and the Banking Structure,* p. 345.

22. *Ibid.,* p. 347

23. On the importance of correspondent services in assisting new entry see Mottor, op. cit., pp. 248-264.

24. *The Report of The President's Commission on Financial Structure and Regulation*, p. 32.

25. Bernard Shull and Paul M. Horvitz, "The Bank Merger Act of 1960: A Decade After," *The Antitrust Bulletin* (Winter 1971), pp. 859-909.

26. Representative Lawrence G. Williams, Hearings on H.R. 11601, 90th Congress, 1st Session, p. 391.

27. The study from which these data are derived is Paul F. Smith, "Recent Trends in the Financial Position of Nine Major Consumer Finance Companies," in John M. Chapman and Robert P. Shay, ed., *The Consumer Finance Industry: Its Costs and Regulation* (New York: Columbia University Press, 1967), pp. 29-53. The data were derived from nine major finance companies. The earlier study was *Consumer Credit Costs, 1949-59* (Princeton, New Jersey: National Bureau of Economic Research, 1964).

28. Thomas A. Durkin, *A High-Rate Market for Consumer Loans: The Small Small Loan Industry in Texas,* prepared for NCCF (1972).

29. *Ibid.*, Table X.; Smith, "Recent Trends. . . .Finance Companies," p. 49.

30. See Milton W. Schober, *Measurement of Retail Credit Costs* (Washington, D.C.: NCCF, 1972). The data cited were originally reported in *Economic Characteristics of Department Store Credit* (New York: National Retail Merchants Association, 1969).

31. *Ibid.*, pp. 102-105.

32. *Ibid.*, p. 103 The data are adjusted as shown below:

	Capital Structure	After-tax cost of capital	Weighted after-tax cost of capital
Long-term debt	15%	2.5%	0.375%
Preferred stock	5	6.0	0.30
Common stock	80	10.0	8.00
Totals	100%		8.675%

33. *1970 Annual Report of the Administrator* (Washington, D.C.: National Credit Union Administration, 1971), p. 5.

34. Thomas F. Cargill, *Performance of Limited-Income Credit Unions: 1969-1970,* prepared for NCCF (1972).

35. *Ibid.*, p. 37.

36. Greer and Shay, Eds., *An Econometric Analysis of Consumer Instalment Credit Markets in the United States*,

Chapter 8

1. Jorie Luteloff Friedman, Testimony, NCCF, Hearings (May 22, 1972).

2. Lynne C. Litwiller, Testimony, NCCF, Hearings (May 22, 1972).

3. Cited in testimony of Congresswoman Martha W. Griffiths, (May 22, 1972) NCCF Hearings.

4. St. Paul Department of Human Rights, "Instalment Loan Survey of St. Paul Banks: Is There Sex Discrimination" p. 3.

5. *Ibid.*, p. 5.

6. *Brown, et al* v. *Board of Education of Topeka, et al* 347 U.S. 483 (May 17, 1954)

7. For a review of the literature, see Bradley R. Schiller, *The Economics of Poverty and Discrimination* (Englewood Cliffs, New Jersey: Prentice Hall, 1972.)

8. *Social Science Quarterly,* Southwestern Social Science Association, (Austin: University of Texas, December, 1968), pp. 643-650.

9. *Ibid.*, p. 648

10. *Ibid.*, p. 649

11. *Ibid.*

12. *Ibid.*

13. Gary G. Chandler, *An Analysis of the Debt Levels of Central City Families.* prepared for NCCF (1972).

14. The independent variables that Chandler found to be significant at the 95 percent level or better in all three tests were liquid assets, non-liquid assets, and family size. In two of the models age squared and education were significant, and in one model income and age were significant.

15. U.S. Department of Commerce, "Characteristics of the Low-Income Population, 1970," *Current Population Reports,* Series P-60, No. 81 (November 1971).

16. *1971 Survey of Consumer Finances* (Ann Arbor: Survey Research Center, University of Michigan, August, 1971), Statistical Report 2, Table 2-3.

17. *Research on Improvements of the Payments Mechanism: The Final Report on Phase I, An Analysis of Payments Transactions and Phase II, Payments Flow Data.* (Prepared for the Federal Reserve Bank of Atlanta by Georgia Tech Research Institute, Georgia Institute of Technology, 1971).

18. Thomas A. Durkin, *A High-Rate Market for Consumer Loans: The Small Small Loan Industry in Texas,* prepared for NCCF (1972).

19. Subcommittee, Credit for Low Income Families, Arden House Credit Committee, "Credit for Low Income Families," (1972).

20. Federal Trade Commission, *Economic Report on Instalment Credit and Credit Sales Practices of District of Columbia Merchants* (Washington, D.C.: U.S. Government Printing Office, 1968.)

21. Cargill, *Performance of Limited-Income Credit Unions: 1969-1970,* prepared for NCCF, (1972).

22. *Ibid.,* Chapter VI.

23. Ronda S. Paul, *Credit and the Low Income Consumer* prepared for NCCF (1972).

24. Hearings on S.2146 and S.2259 before the Subcommittee on Financial Institutions of the Committee on Banking and Currency, U.S. Senate, 91st Congress, 1st Session, January 14 and 15, 1970, p. 115.

25. Robert P. Shay, *The Impact of State Legal Rate Ceilings Upon the Availability and Price of Consumer Instalment Credit,* (Washington, D.C.: NCCF, 1972

26. U.S. Department of Commerce, "Characteristics of the Low-Income Population: 1971," *Current Population Reports,* Series P-60, No. 82 (July, 1972), pp. 3-4.

27. Alabama, Alaska, Mississippi, Montana, North Carolina, Oklahoma, South Carolina, and Texas.

Chapter 9

1. 12 U.S.C. 85 (1964).

2. Legal Opinion No. 1226-A, dated May 26, 1944, by Russel D. Miller, Counsel, Federal Deposit Insurance Corporation, to J. E. Blomgren, Review Examiner, Federal Credit Union Station.

3. *The Report of The President's Commission on Financial Structure and Regulation* (December, 1971), p. 50

4. Seventh draft of the Uniform Small Loan Law, Section 4 (b).

5. William L. Sartoris, *Analysis and Administration of Convenience and Advantage Licensing in the Small-Loan Industry.* (Unpublished Ph.D. dissertation, Purdue University, 1970), p. 17.

6. These conclusions are based on John M. Chapman and Robert P. Shay, eds. *The Consumer Finance Industry: Its Costs and Regulation* (New York: Columbia University Press, 1967), p. 113. Tight states listed are Connecticut, Massachusetts, Michigan, New Jersey, New York, South Carolina, and Virginia. However, New York has since relaxed restraints and probably should be classed as 'medium," along with Florida, Nebraska, Nevada, New Mexico, and Ohio.

7. Edwin M. Stokes, " 'Convenience and Advantage' Animal--How it Shapes Up on Its 24th Birthday," *Pers. Fin. L. Q. Rep.,* 10 (Summer, 1956), p. 92.

8. For a full review of the arguments see Sartoris, *Analysis and Administration of Convenience and Advantage Licensing in the Small-Loan Industry,* pp. 18-44.

9. Statement of Paul H. Douglas Before the Legislature of the Commonwealth of Massachusetts on the Uniform Consumer Credit Code, Hearings on Consumer Credit Regulations Before the Subcommittee on Consumer Affairs of the Committee on Banking and Currency, House of Representatives, 91st Congress, 1st Session, pp. 142-143.

10. *The Report of The President's Commission on Financial Structure and Regulation.,* p. 60

11. This assumes that the $600 loans are obtained under the Florida small loan act. If the loans were made under the consumer finance act, the excess charge would be $42.

12. George J. Benston, *The Availability of Credit When Consumer Finance Companies Can No Longer Offer Renewals: The Case of Maine,* prepared for NCCF (1972).

13. Rolf Nugent, "Three Experiments with Small-Loan Interest Rates," *Harv. Bus. Rev.* 12 (October, 1933), pp. 35-46.

14. "An Empirical Study of the Arkansas Usury Law: 'With Friends Like That . . .' ." 1968 *Illinois L. Forum* 544, 574.

Chapter 10

1. See, for example, the note of a commercial bank for a personal loan shown in Robert W. Johnson, *Methods of Stating Consumer Finance Charges* (New York: Graduate School of Business, Columbia University, 1961), p. 36.

2. *Cost of Personal Borrowing in the United States* (Boston: Financial Publishing Company, 1971), p. 100.

3. Jean M. Due, "Consumer Knowledge of Instalment Credit Charges," *J. Marketing*, 30 (October 1955), p. 164. Lois Scott Hoskins, "Interest Rates Paid for Automobile Credit by San Francisco Bay Area Families," unpublished M. A. thesis, University of California, September 1958, cited in Wallace P. Mors, *Consumer Credit Finance Charges* (New York: National Bureau of Economic Research, 1965), pp. 81-82. In a sense, these studies were biased in favor of the annual percentage rate as a means of uniform rate disclosure. The surveys did not inquire into consumers' ability to quote the add-on rate, for example.

4. F. Thomas Juster and Robert P. Shay, *Consumer Sensitivity to Finance Rates: An Empricial and Analytical Investigation* (New York: National Bureau of Economic Research, 1964), p. 73.

5. George Katona, William Dunkelberg, Gray Hendricks and Jay Schmiedeskamp, *1969 Survey of Consumer Finances* (Ann Arbor: Survey Research Center, University of Michigan, 1970), p. 19.

6. Juster and Shay, *Consumer Sensitivity to Finance Rates: An Empirical and Analytical Investigation*, p. 61.

7. Roger S. Barrett, *Compilation of Consumer Finance Laws* Washington, D.C.: National Consumer Finance Association, 1952), pp. 680-682. The "rate of charge" was a monthly rate on the declining unpaid balance, not an annual rate. As of the end of 1964, eleven states required a posting of the rate schedule (Alabama; Alaska; California; Hawaii; Iowa; Michigan; Minnesota; New Mexico; Vermont; Virginia; and Wisconsin. Barbara Curran, *Trends in Consumer Credit Legislation* (Chicago: University of Chicago Press, 1965) p 38.

8. Curran, *Trends in Consumer Credit Legislation*, pp. 293-300.

9. *Ibid.*, pp. 74-75.

10. Minnesota, New Mexico, North Dakota, South Dakota and Wisconsin. *Ibid.*, p. 38, n. 212.

11. Hawaii Rev. Stat. sec. 408-17 (1) (1968)

12. Hearings before the Subcommittee on Consumer Affairs of the Committee on Banking and Currency, House of Representatives, 90th Cong., 1st Sess. on H.R. 11601, Consumer Credit Protection Act (Washington, D.C.: U.S. Government Printing Office, 1967). Testimony of Rev. Robert J. McEwen, pp. 365-399; and Robert L. Meade, pp. 567-590.

13. Jacob S. Ziegel, "Consumer Credit Regulation: A Canadian Consumer-Oriented Viewpoint," 68 *Colum. L. Rev.* 488, 507-508 (1968).

14. Bank Act 1967, ch. 87, sec. 92(2) and 67-101 Can. Gazette, Part II, p. 1586; SOR 167-504 (1967).

15. Advertisements (Hire-Purchase) Act 1967, Ch. 42, sec. 1(3) and Sched. 1, Part III. The direct ratio method was specified as the method to estimate the annual percentage rate.

16. Aubrey L. Diamond, ed., *Instalment Credit* (London: Stevens & Sons, 1970), p. 7.

17. Limitation and Disclosure of Finance Charges Act, 1968 (Act. No. 73 of 1968) (Disclosure required only upon demand).

18. *American Banker*, December 20, 1967, p.91.

19. *Ibid.*

20. "1959 Survey of Consumer Finances: the Financial Position of Consumers," *Federal Reserve Bulletin*, 45 (July 1959), p. 721.

21. George Katona, James N. Morgan, Jay Schmiedeskamp, John A. Sonquist, *1967 Survey of Consumer Finances* (Ann Arbor Survey Research Center, University of Michigan, 1968), p. 145.

22. *Ibid.*, p. 146

23. Hearings on S.5 (1967), p. 49. There are some minor differences in actual yields on savings accounts depending upon the method of calculating the interest earned.

24. Testimony of Andrew J. Biemiller, Director, Department of Legislation, AFL-CIO, Hearings on S. 1740 (1961), p. 450.

25. Hearings on S. 1740 (1961), p. 852.

26. "Viewed in the aggregate, delinquency, repossession, and loss rates rise during recessions and fall during business expansions," Geoffrey H. Moore and Philip A. Klein, *The Quality of Consumer Instalment Credit* (New York: National Bureau of Economic Research, 1967), p. 149.

27. Hearings on S. 1740 (1961), p. 46.

28. Homer Kripke, "Gesture and Reality in Consumer Credit Reform," 44 *N.Y.U. L. Rev.* 1,2-3 (1969).

29. Statement of Helen Hall, Director, Henry Street Settlement, New York, Hearings on S. 2755 (1960), p. 116.

30. Hearings on S. 1740 (1961), p. 1. The appropriate division of labor between the Federal and state governments was re-emphasize in the final report of the Senate Committee on Banking and Currency Accompanying S. 5:

> . . . The National Conference of Commissioners on Uniform State Laws has been working diligently on a proposed consumer credit code to recommend to the various state legislatures beginning in 1969. The committee applauds and endorses the worthwhile efforts of the National Conference of Commissioners on Uniform State Laws and urges the states act favorably in adopting a uniform consumer credit

code. Although this bill would be limited to the disclosure aspects of consumer credit, the proposed consumer credit code goes considerably beyond disclosure and, in fact, proposes a variety of beneficial changes in the entire consumer credit area. . . The committee is also hopeful that the provision under section 6(b), whereby creditors will be exempt from compliance with the Federal law if their State enacts substantially similar legislation, will serve as an incentive to the States to act favorably upon the proposed consumer credit code. In this respect the committee believes the Federal truth in lending law and the proposed consumer credit code are supplementary rather than competing alternatives. Senate Report 392, pp. 8-9.

31. Kenneth McLean, "The Federal Consumer Credit Protection Act," *Bus. Lawyer*, 24 (November 1968), p. 206.

32. William Proxmire, "This is the Year for Truth-in-Lending," *Credit World*, 55 (March 1967), p. 8.

33. McLean, "The Federal Consumer Credit Protection Act," p. 202.

34. Robert P. Shay and Milton W. Schober, *Consumer Awareness of Annual Percentage Rates of Charge in Consumer Instalment Credit: Before and After Truth in Lending Became Effective* (Washington, D.C., NCCF, 1972). In this study, awareness zones for credit other than open end were not assigned upper limits. Therefore, the awareness figures reported may have somewhat of an upward bias, because some of the high rates reported by respondents may have been guesses and not really indicative of awareness.

35. George S. Day and William K. Brandt, *A Study of Consumer Credit Decisions: Implications for Present and Prospective Legislation*, prepared for NCCF (1972).

36. Another recently published study measures awareness by comparing the ratio of the estimated APR to the "actual" APR. The study is deficient in that it omits the "don't knows," with the result that changes in the levels of unawareness cannot be measured. In addition, the formula used to estimate the actual APR understates the true rate. Since consumers also characteristically underestimate the APR, the procedure results in an overstatement of the levels of awareness. Lewis Mandell, "Consumer Perception of Incurred Interest Rates: An Empirical Test of the Efficiency of the Truth-in-Lending Law," *J. Fin.* 26 (December 1971), pp. 1143-1153.

37. With the growth of credit scoring, credit grantors will probably be in a position, if they desire, to discriminate more sharply in terms of price between high risk and low risk credit applications. However, this does not change the analysis. It only adds the dimension that given the credit terms requested *and given their risk class*, consumers will be offered credit at the same price.

38. Comment "The Impact of Truth in Lending on Automobile Financing–An Empirical Study," 4 *U.Cal.Davis L. Rev.* 179, 194-195 (1971).

39. McLean, "The Federal Consumer Credit Protection Act," pp. 206-207.

40. Brandt-Day report that of credit buyers who said they noticed any information on the credit agreement only 8 percent said that they used it or planned to use it to shop in the future. Only 57 percent of credit buyers notices something; of these just over half noticed percentage information (Brandt-Day, Chapter V).

41. "Consumer Knowledge and Perception of Consumer Credit," (Ann Arbor: Survey Research Center, University of Michigan, 1971), p. 28.

42. Juster and Shay, *Consumer Sensitivity to Finance Rates: An Empirical and Analytical Investigation*, p. 59

43. Paul F. Smith, *An Economic Evaluation of the Competitiveness of Consumer Credit Markets*, (Draft of paper prepared for NCCF).

44. Juster and Shay, *Consumer Sensitivity to Finance Rates: An Empirical and Analytical Investigation*, p. 14.

45. The data in Exhibit 10-2 are influenced by the fact that those with incomes of less than $5,000 include elderly individuals who have little in the way of current income, but relatively large amounts of liquid assets. Their infrequent use of credit may reflect more a lack of demand rather than a rationing of credit.

46. Terry Deutscher, *Credit Legislation Two Years Out: Awareness Changes and Behavioral Effects of Differential Awareness Levels*, prepared for NCCF (1972).

47. For this calculation sales credit has been defined as service credit, charge accounts, repair and modernization loans, other consumer goods paper, and automobile paper, excluding direct auto loans held by commercial banks.

48. Walter Polner, *Credit Unions in the 1970's* (Madison: CUNA Supply Cooperative, 1971), p. 59.

49. U.S. Department of Commerce, *Current Population Reports* (Series P-20, No. 194), February 19, 1970, p. 14. Polner, *Credit Unions in the 1970's*, p. 63.

50. George Katona, et al., *Survey of Consumer Finances*, p. 33.

51. Federal Trade Commission, *Economic Report on Instalment Credit and Retail Sales Practices of District of Columbia Retailers* (Washington, D.C.: U.S. Government Printing Office, 1968), p. 16. (Data on comparative APR's are on page 26.)

52. *Ibid.*, p. 21.

53. Robert W. Pullen, *The Impact of Truth-in-Lending Legislation: The Massachusetts Experience* (Boston: Federal Reserve Bank of Boston, 1968), pp. 47-48.

54. Monroe P. Friedman, "Using Simulation Techniques to Predict the Behavioral Effects of New Laws: The Case of Truth-in-Lending Legislation and the Consumer," *Journal of Applied Psychology*, 54 (August 1970) pp. 297-301.

55. Pullen, *The Impact of Truth-in-Lending Legislation: The Massachusetts Experience*, pp. 51-55.

56. William C. Dunkelberg and James Stephenson, *The Rate of Return on Consumer Durables,* prepared for NCCF (1972).

57. Hearings on S. 1740 (1961), p. 46.

58. Board of Governors of the Federal Reserve System, *Consumer Instalment Credit: Growth and Import,* Part I Volume I (Washington, D.C.: U.S. Government Printing Office, 1957), p. 281.

59. 449 F.2d 235 (1971).

60. U.S. Department of Housing and Urban Development and the Veterans Administration, *Report on Mortgage Settlement Costs* (January 1972), p. 110.

61. As Congresswoman Sullivan observed: "We would not, in our bill, stop the advertising of credit—only the misleading type of advertising of credit—only the misleading type of advertising where they might advertise 4 or 3 percent and then you would come in and find it is several times that much." Hearings on H.R. 11601, p. 777.

62. Pullen, *The Impact of Truth-in-Lending Legislation: The Massachusetts Experience,* p. 26.

63. James J. White and Frank W. Munger, Jr., "Consumer Sensitivity to Interest Rates: An Empirical Study of New-Car Buyers and Auto Loans," 69 *Mich. L. Rev.* 1207, 1240 (1971). In fairness to the authors, they conclude the paragraph by observing: "However, our findings make us rather pessimistic about the effectiveness of disclosures, whenever and however made, in today's market."

64. *Consumer Credit: Report of the Committee* (Chairman, Lord Crowther), Vol. 1 (London: Her Majesty's Stationary Office, 1971), p. 260.

65. Comment, "The Impact of Truth-in-Lending on Automobile Financing: An Empirical Study," p. 200.

66. Trudy Lieberman, "Auto Loan Rate Quotes Remain Deceiving Despite U.S. Order," *Detroit Free Press,* February 28, 1972.

67. Comment, "The Impact of Truth-in-Lending on Automobile Financing: An Empirical Study," pp. 200, 201.

68. Hearings before the Subcommittee on Consumer Affairs of the Committee on Banking and Currency, House of Representatives, 92nd Congress, 2nd Session, March 23, 1972.

Chapter 11

1. William C. Dunkelberg and James Stephenson, *The Rate of Return on Consumer Durables,* prepared for NCCF (1972). The paper documents the rate of return received by consumers by investments in certain household durables. The direct return is augmented by nonmonetary benefits, such as convenience, social approval, and so on.

2. Interest payments include interest on mortgages and probably omit finance charges on some forms of instalment credit where the finance charge is included in the face amount of the contract. "U.S. National Income and Product Accounts, 1967-70." *Survey of Current Business,* 51 (July, 1971), p. 22.

3. Federal Board of Vocational Education, *Home Economics Education, Organization and Administration,* Bulletin No. 28, Home Economics Series No. 2 (Washington, D.C.: U.S. Government Printing Office, 1918), p. 16.

4. Joseph N. Uhl, et. al., *Survey and Evaluation of Consumer Education Programs in the United States,* Vol. I (Study prepared for the U.S. Department of Health, Education, and Welfare, March, 1970), p. 19.

5. Vocational Education Amendments of 1968, PL 90-576, Title 1, Part F, 82 Stat. 1085 (October 16, 1968).

6. The President's Office of Consumer Affairs has developed guidelines for consumer courses with considerable emphasis on teaching from kindergarten through grade 6.

7. Sharon Isaacson Ritt, "An Experimental Study of the Capacity of Fourth and Fifth Grade Children to Understand Economic Concepts," *Research in Elementary School Economics: Occasional Papers Numbers 30* (Chicago: Industrial Relations Center, Univ., of Chicago, 1969), pp. 11-13.

8. A program including consumer education as well as job training has been designed specifically for the student who may never complete high school. See Julia I. Dalrymple *et.al., Preparation for a Dual Role: Homemaker and Wage Earner,* Vols. I and II (U.S.Department of Health, Education, and Welfare, 1971).

9. Jan Armstrong and Joseph N. Uhl, "Survey of Consumer Education Programs in the United States," *J. Home Ec.,* 63 (October, 1971), p. 526.

10. *Consumer and Homemaking Education* (Washington, D.C.: American Home Economics Association, 1971), pp. 37-38.

11. Helen Hall, "Values and Dangers of Consumer Credit for Lower Income Groups," *Proceedings* of the National Consumer Credit Conference for 1953 (New York: New York University Schools of Business, 1953), pp. 33-34.

12. Barbara J. Bowser, *Concepts Concerning Money: A Comparison of Selected Lower-and Middle-Class Eighth Grade Home Economics Girls in Arkon, Ohio* (Masters Thesis, Kent State University, 1969).

13. A. Donald Beattie, *Relationships between High School Pupil's Information and Attitudes toward Personal Finance* (Ph.D. Dissertation, University of Minnesota, 1962).

14. *The Washington Post,* June 3, 1971, p. B-15

15. Wilmer O. Maedka, "Consumer Education in the Secondary School," *Ill. J. Ed.,* 60 (October, 1969), p. 7.

16. Joint Council on Economic Education, Developmental Economic Education Program—Cooperating Schools Program, (1970), p. 1.

17. George C. Dawson, "The Economic Preparation of Future Business Teachers," *Bus. Ed. World,* 49 (June, 1969), pp. 11, 13.

18. Uhl, *et. al.*, p. 111.

19. Uhl and Armstrong, "Adult Consumer Education Programs in the United States," *J. Home Ec.*, 63 (November, 1971), pp. 591-595.

20. Sylvia Lane, *Preliminary Evaluation of the Section 237 Housing Counseling Program,* prepared for HUD and NCCF. Unpublished.

21. Uhl, *et. al.*, p. 93.

22. Uhl and Armstrong, "Adult Consumer Education Programs in the United States," p. 593.

23. *Ibid.*, p. 594.

24. "Everybody Wants In," *Credit Union Magazine,* 36 (March, 1971), p. 21. Use of educational television to make law more understandable to the general public is described in Donald J. Horowitz, "Where Public Service and Self-Interest Meet," 57 *Am. Bar Assn. J.*, p. 783-787 (1971).

25. "Operation Stop Gap," (ERIC Information System, Bureau of Research, U.S. Office of Education).

26. *Final Report of the Select Committee of the Ontario Legislature on Consumer Credit* (1965), p. 11.

27. *Consumer Credit: Report of the Committee* (Chairman, Lord Crowther), Vol. 1 (London: Her Majesty's Stationary Office, 1971), p. 378.

28. *Annual Report of the Director of the Administrative Office of United States Courts–1971* (Washington, D.C., 1972)

29. David Caplovitz, *Debtors in Default,* Vol. 1 (New York: Bureau of Applied Social Research, Columbia University, 1970), p. 2-16.

30. David T. Stanley and Marjorie Girth, *Banktruptcy: Problem, Process, Reform* (Washington, D.C.: The Brookings Institution, 1971), pp. 42-43. The sample was probably biased in favor of better educated consumers because of the high nonresponse portion.

31. *American Banker,* July 21, 1959, p. 12.

32. *Family Credit Counseling–An Emerging Community Service,* Summary Report (New York: Family Service Association of America, 1967), p. 13.

33. Anna K. Williams, *Costs of Failure in Personal Financial Management* (Unpublished master's dissertation, Department of Economics, Indiana University, January, 1970), p. 57.

34. John H. Stennis, "Mississippi Becomes 28th State to Outlaw Debt Adjusting," *Pers. Fin. L. Q. Rep.* 25 (Summer 1971), pp. 75 ff. A survey of the abuses may be found in "Debtor Beware," a series by Miriam Ottenberg in *The Evening Star* (Washington, D.C., 1967).

35. Grant L. Misbach, *Personal Bankruptcy in the United States and Utah* (Salt Lake City: College of Business, University of Utah, 1964), pp. 29-32. See also, Haden, "Chapter XIII Wage Earner Plans–Forgotten Man Bankruptcy," 55 *Kentucky L. J.*, 564 (1967). Of a total of 9,524 wage earner petitions filed in Kansas City, Kansas during 1956-1965, 535 were second-time petitions, 101 third-time petitions, 19 fourth-time petitions, five fifth-time petitions, one sixth-time petition, and one ninth-time petition. *Ibid.*, pp. 595-97.

36. An early proponent of the concept was Robert O. Herrmann, "Families in Bankruptcy–A Survey of Recent Studies," *Journal of Marriage and the Family,* 28 (August, 1966), p. 330.

37. Joe Lee, "The Counseling of Debtors in Bankruptcy Proceedings," *Am. Bankr. L.J.*, 387-404 (1971).

38. One study of consumer bankrupts showed 94 percent to be married. Robert Dolphin, Jr., *An Analysis of Economic and Personal Factors Leading to Consumer Bankruptcy* (East Lansing, Mich: Bureau of Business and Economic Research, Michigan State University, 1965), pp. 43-48.

Chapter 12

1. Such a system would provide for the virtually instantaneous debiting and crediting of deposit balances. Transactions could include the granting of credit under lines of credit repayable in instalments, as under current revolving credit arrangements.

2. Such leads and lags can cause severe problems for some suppliers and users of credit. These are explored in Irwin Friend, *et. al., Study of the Savings and Loan Industry* (Washington, D.C.:Federal Home Loan Bank Board, 1969), and by the *Report of The President's Commission on Financial Structure and Regulation.*

3. U.S. Department of Commerce, *Current Population Reports* (Series P-25, No. 470), November, 1971, pp. 13-14.

4. For example, the National Bank of Southfield, Southfield, Michigan has announced a 48-month auto loan plan available to new car buyers. *American Banker,* April 25, 1972, p. 10.

5. For a discussion of this last point, see Heln Manning Hunter, "A Behavioral Model of the Long-Run Growth of Aggregate Consumer Credit in the United States," *Rev. Ec. & Stat.*, 48 (May, 1966), pp. 124-140.

6. The proportion of outstanding instalment credit at retail outlets (excluding auto dealers) composed of balances in revolving credit accounts is estimated from Andrew F. Brimmer, "Growth and Profitability of Credit Card Banking," paper presented at 1971 National Credit Card Conference of the American Bankers Association, New Orleans, Louisiana, October, 1971, Table 6. Data on revolving credit at commercial banks are from Federal Reserve Statistical Release G. 18 (June 5, 1972).

7. Thomas R. Saving, "The Macro-Economic Impact of Credit Cards," paper presented at "The Impact of Credit Cards–A Forum," San Francisco, California, June, 1970, p. 7.

8. *Economic Characteristics of Department Store Credit* (New York: National Retail Merchants Association, 1969), pp. 53, 73. The per account data relating to number of transactions and amount per transaction are from 11 stores, whereas other data are provided by 10 large stores and five small stores.

9. Dee W. Hock (President, National BankAmericard, Inc., San Francisco), "Data Processing Must Serve the Bank Card Carrier," *American Banker*, December 1, 1971, p. 4A. The average balance is estimated from other data and is not directly comparable to the other figures cited. The average sales draft for Bank Americard holders in the United States in the fourth quarter of 1971 was $18.23, compared to $17.70 for the fourth quarter of 1970. *American Banker*, February 2, 1972, pp. 3, 14.

10. *Economic Characteristics of Department Store Credit*, p. 81.

11. Based largely on Brimmer, "Growth and Profitability of Credit Card Banking."

12. *Ibid.*, p. 5. Four banks in the Richmond district reported aggregate charge-offs amounting to 10.48 percent of year-end outstandings (Table 9).

13. Dennis W. Richardson, *Electric Money: Evolution of an Electronic Funds-Transfer System* (Cambridge: The MIT Press, 1970), p. 102. One wonders if a bad head cold might temporarily eliminate a consumer from the credit system.

14. Kenneth A. McLean, "Public Policy Implications of Credit Card Growth," paper delivered to the Institute of Business and Economic Research of San Jose State College, San Francisco, Califronia, June 6, 1970, p. 16.

15. *Economic Characteristics of Department Store Credit*, pp. 55-56. Data reflect an 8 percent cost of capital.

16. *Research on Improvements of the Payments Mechanism: the Final Report on Phase I, An Analysis of Payments Transactions and Phase II, Payments Flow Data.* (Prepared for the Federal Reserve Bank of Atlanta by Georgia Tech Research Institute, Georgia Institute of Technology, 1971), Vol. I, p. 53. (Hereafter, *Research on Improvements of the Payments Mechanism.)*

17. *Ibid.*, Vol. 3, Table G-6.

18. *American Banker*, January 28, 1972, p. 1.

19. Guy G. Gordon, John J. Wheatley, *et. al.*, *The Impact of a Consumer Credit Interest Limitation Law: The State of Washington* (Seattle: Graduate School of Business Administration, 1970), p. 63.

20. *American Banker*, November 12, 1971, p. 1.

21. *Wall Street Journal*, April 30, 1971, p. 4. Retailers reacted in much the same manner as did the banks in the face of lower credit revenues. This same article reported that Daytons stopped accepting all applications for revolving credit accounts. Open end credit accounts were discontinued in Gamble-Skogmo retail stores in Minnesota and Wisconsin. *Home Furnishings Daily*, July 2, 1971, p. 2.

22. *Research on Improvements of the Payments Mechanism*, Vol. III, Table G-22.

23. *Ibid.*, Vol. I, p. 63.

24. Brimmer, "Growth and Profitability of Credit Card Banking," Table 3. However, deposits are also concentrated in the hands of large banks, with the 50 largest holding 47.4 percent of the deposits of all commercial banks at the end of 1970. U.S. Bureau of the Census, *Statistical Abstract of the United States, 1971* (Washington, D.C.: U.S. Government Printing Office, 1971), p. 437.

25. Robert F. Lanzillotti, "Antitrust Aspects of the Credit Card 'Industry'," paper presented at "The Impact of Credit Cards–A Forum," San Francisco, 1970, p. 5.

26. The following quotation from a banker is pertinent: "It is commonly known that when banks entered the charge card field, merchant discounts were lower, and, in some cases reduced to a ridiculous figure.... If cards are used more for convenience only, the banks may very well have to consider an annual fee or membership charge for its cardholders. Perhaps bankers will abstract this fee in innovative ways, such as applying the fee to checking account service charges, or eliminating the fee when a checking or savings balance is maintained at a specified minimum level. The cross-selling techniques now developing in the retail banking field made possible with the help of computers, are showing up in surprisingly varied ways." "Banks May Be Forced into Instituting An Annual Charge on its Credit Cards," *American Banker*, October 13, 1970, pp. 57, 58.

27. Brimmer, "Growth and Profitability of Credit Card Banking, Table 19.

28. Calculated from *Research on Improvements of the Payments Mechanism*, Vol. 3, Table F-4.

29. Brimmer, "Growth and Profitability of Credit Card Banking," Table 19.

30. "National Bank Americard Bars Dual Card System," *American Banker*, November 8, 1971, p. 1. The ban on dual membership has been challenged in an antitrust suit by Worthen Bank & Trust Co., Little Rock, Arkansas. *American Banker*, December 1, 1971, p. 1.

31. Letter to Rober L. Meade, Executive Director, NCCF, February 8, 1972.

32. House Bill No. 5072.

33. *The Report of The President's Commission on Financial Structure and Regulation*, p. 33.

34. Hearings before the Subcommittee on Consumer Affairs of the Committee on Banking and Currency, U.S. House of Representatives, 90th Congress, 1st Session on H.R. 11601, Consumer Credit Protection Act, p. 264.

35. The existence of numerous competing credit grantors does not rule out the possibility of a consumer having only one credit card. The survey in metropolitan Atlanta found that about 61 percent consumers favored a universally acceptable charge card. Some 18 percent preferred the current multiple card system, and 21 percent had no opinion. *(Research on Improvements of the Payments Mechanism*, Vol. III, Table F-8). Until fairly recently it was common practice for a consumer to have only one charge plate providing credit at a number of competing retailers. The plate was merely notched for each of the stores where the consumer had an account. It should not be overly difficult to "notch" a universal credit card electronically, so that a consumer could designate his credit source at the point of sale or at the time he was obtaining a cash advance.

36. Lanzillotti, "Antitrust Aspects of the Credit Card 'Industry'," p. 7.

37. Leo Grebler, *The Future of Thrift Institutions* (Danville, Ill.: Joint Savings and Loan and Mutual Savings Bank Exchange Groups, 1969), p. 43.

38. For the period 1952-1966, Grebler found correlation coefficients between the yearly growth rate of auto financing and personal loans to the yearly growth rate of one- to four-family home mortgages of 0.483 and 0.449 respectively. *Ibid.*, p. 34. Thus net inflows and outflows on consumer loans and home mortgage loans are reinforcing rather than offsetting. Another study shows the median lead in relation to business cycle turns of changes in consumer instalment debt as ten months and the median lead for changes in mortgage debt as eight months. However, only four business cycle turns are covered by the data on mortgage debt. Geoffrey H. Moore and Julius Shiskin, *Indicators of Business Expansion and Contractions* (New York: National Bureau of Economic Research, 1967), pp. 38-39.

39. *Functional Cost Analysis, 1970--Average Banks*, pp. A13-14.

40. The President's Commission on Financial Structure and Regulation recommends that "savings and loan associations and mutual savings banks be granted. . . authority to: . . . make loans on mobile homes, without restrictions on sizes and types. . . make secured and unsecured consumer loans in amounts not to aggregate in excess of 10 percent of total assets. *The Report of The President's Commission on Financial Structure and Regulation*, pp. 31-32.

41. This Commission again notes its concurrence with The President's Commission on Financial Structure and Regulation. That Commission has recommended that "by state laws, the power of savings and loan associations and mutual savings banks to branch, both *de novo* and by merger, be extended to a statewide basis, and that all statutory restrictions on branch or home office locations based on geographic or population factors or on proximity to other associations or banks or branches thereof be eliminated." Identical branching powers are recommended for commercial banks. *Ibid.*, pp. 59-62.

42. "Member Bank Purchase of Stock of Operations Subsidiaries," *Federal Reserve Bulletin*, 54 (August, 1968), p. 682.

43. For a discussion and references, see Grebler, *The Future of Thrift Institutions*, pp. 49-50. See also George J. Benston, *The Cost of Consumer Loans at Consumer Finance Companies and Commercial Banks*, prepared for NCCF, (1972).

44. Such diversification is unlikely to reduce significantly the overall risk of credit grantors. Cyclical changes affect most consumers, and, therefore, there is probably a fairly high correlation between repayments from various classes of consumers. Since the positive correlation is not perfect, credit grantors will achieve some reduction in the variance (risk) of their returns.

U.S. GOVERNMENT PRINTING OFFICE : 1973 O-496-072